

Before the
UNITED STATES COPYRIGHT ROYALTY JUDGES
Washington, D.C.

In the Matter of

**MECHANICAL AND DIGITAL
PHONORECORD DELIVERY RATE
ADJUSTMENT PROCEEDING**

Docket No. 2006-3 CRB DPRA

CORRECTED REBUTTAL TESTIMONY OF

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May 2008

TESTIMONY OF BRUCE P. BENSON
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I. Qualifications

I am a Senior Managing Director at FTI Consulting, Inc., and global leader of FTI's Entertainment & Media practice. FTI is a consulting firm that provides advice on a global basis to major corporations and law firms in the areas of corporate finance, economic consulting, forensic and litigation consulting, strategic communications and technology. The Entertainment & Media group at FTI provides services in a variety of areas including digital marketing strategies, digital revenue management, optimizing rights revenues, and economic modeling.

I have been a specialist in entertainment and media for 20 years. Prior to my current position with FTI, I held the following positions:

- Entertainment Industry Leader, SAP America
- EVP Corporate Strategy, Young & Rubicam
- SVP Sony Music
- Management Consulting Partner, Price Waterhouse, Entertainment & Media Industry

I have experience in all aspects of media and technology and have consulted on a broad range of areas including strategy and market planning, economic analysis, operational effectiveness, systems development, royalty accounting, intellectual property management and digital distribution.

I am a recognized expert in media and advertising and have helped some of the world's leading companies achieve their strategic goals, including Sony Music, Microsoft, Bertelsmann, Viacom, Young & Rubicam, Ogilvy, Harper Collins, NBC and Pearson. I have pioneered various new forms of digital distribution and advertising over the internet, and co-led conferences with key Harvard strategists on intellectual property management and copyright law. I have given many speeches and presentations on digital distribution, the changing economics of media, and intellectual property management. I have applied for various patents on electronic book delivery, the internet delivery of ad-supported video content over peer-to-peer networks, and the anonymous financial settlement of virally distributed content.

I have led over 200 projects with clients, including media executives both in the United States and overseas. These projects have focused on strategic planning, revenue optimization, operational effectiveness and cost containment, internet distribution and large-scale IT project management.

Of particular relevance is my tenure at Sony Music where for 5 years from 1994 through 1998 I was head of U.S. IT operations and head of strategic global improvement projects including the renovation of royalty accounting, finance, distribution, warehousing and manufacturing. In 1997 I authored, along with Ken Pohlman, Professor of Digital Music at the University of Florida, the first research papers regarding the sale and distribution of songs over the internet.

As a regular part of my work I develop financial projections and models for many clients. I have undertaken dozens of analyses similar to the analysis embodied in the testimony below.

II. Purpose of Testimony

The purpose of my testimony is to respond to claims made by music publishers that the transition from physical to digital distribution of music will increase profit margins for the record companies and justify the payment of higher mechanical royalties to the music publishers. In addition, I calculate the profitability of various music formats (e.g., physical CDs, digital singles, ringtones) at the song level (that is, the profitability of each individual song or track) in order to assess the effect of the music publishers' proposed increase in royalty rates for the various formats.

This analysis covers the period from 1999 – 2006, and relies on testimony compiled by Linda McLaughlin regarding the financials of the major record labels, which has been cited by experts for both the music publishers and the RIAA, including Teece¹ and Enders.² I have updated the McLaughlin data as discussed below. In addition, I am relying on net wholesale revenue and unit shipments as published by the RIAA and PriceWaterhouseCoopers.³ Although the main focus of my testimony is format profitability for the periods with actual data from 1999 – 2006, I will also briefly touch on the anticipated future profitability of

¹ RIAA Trial Ex. 64 (Teece WDT)

² CO Trial Ex. 10 (Enders WDT)

³ Wholesale revenue and unit shipments as published by RIAA: RIAA, 2006 Year-End Shipment Statistics, Manufacturers' Unit Shipments and Retail Dollar Value; Recording Industry Association of America, Inc., Net Shipments, Direct & Special Markets and Digital Distribution, Gross Shipment and Return: All Disc and Cassettes, For the Year Ending December 31, 2006 (Dated March 15, 2007); Recording Industry Association of America, Inc., Net Shipments, Direct & Special Markets and Digital Distribution, Gross Shipment and Returns: All Disc and Cassettes, For the Year Ending December 31, 2005 (Dated April 4, 2006); Recording Industry Association of America, Inc., Net Shipments Worksheets, Direct & Special Markets Report, Gross Shipments and Returns: All Discs and Cassettes, For the Twelve Months Ending December 31, 2004 (Dated February 25, 2005); Recording Industry Association of America, Inc., Net Shipments Worksheets, Direct & Special Markets Report, For the Twelve Months January Through December 2001 (Dated February 13, 2002).

digital distribution based on forecasts published by Veronis, Suhler and Stevenson and previously cited to the Court.⁴

III. Key Findings and Structure of This Testimony

As set forth in more detail throughout this testimony, I have analyzed the economics of the major recorded music companies in the United States. I have arrived at the following key findings regarding the financial performance of key music formats including CD albums, digital albums, digital singles and ringtones/ringbacks:

1. CD albums are profitable for the record companies, but profitability has been declining as wholesale prices for CDs fall. In 2006, the record companies earned a profit of approximately \$.024 per song or track on a CD album.
2. Digital albums are unprofitable for the record companies. This is because wholesale prices for digital albums are low compared to CD albums, and the mechanical royalty for digital albums is higher than the effective mechanical royalty rate for CD albums. This combination of low wholesale price and high mechanical rate more than offsets the lower manufacturing and distribution costs for digital products. In 2006, the record companies lost approximately \$.05 for each song or track on a digital album.
3. Digital singles are profitable for the record companies, averaging a profit of \$.10 per song in 2006.
4. Ringtones are the most profitable form of digital distribution, averaging a profit per song of \$.39 in 2006.
5. I understand that the music publishers have proposed separate royalty rates for digital downloads, physical CDs, and ringtones. I further understand that the music publishers' proposed rate for digital downloads is higher than the rate proposed for physical CDs. However, the data in this report demonstrates that digital downloads (excluding ringtones, for which the music publishers propose a separate rate) are only slightly more profitable than physical CDs.

⁴ Veronis Suhler Stevenson, *Communications Industry Forecast, Twenty-First Edition, Historical and Projected Expenditures for 19 Industry Segments (2007)*, cited in RIAA Trial Ex. 64 (Teece WDT), pp 51-58; CO Trial Ex. 10 (Enders WDT), pp 55-59.

Combining the data for digital album downloads and digital single downloads, and excluding ringtones, in 2006 the margin for digital downloads in 2006 was 6.9%, just 3.4% higher than the 3.5% margin for CD albums in that year. However, this is only after license revenue is taken into account; based on net sales revenue, both formats are unprofitable.

6. If current trends continue, the margin on sales of digital albums and digital singles will decline, and perhaps become negative. This is because sales of digital albums, which are unprofitable, are growing faster than sales of digital singles, and losses on the sales of digital albums will increasingly offset the profits on the sale of digital singles. From 2004 to 2006, digital album sales grew by a compound annual growth rate of 141.4%, compared to growth of digital singles sales of 110.5%.
7. The margins for downloads of digital singles and digital albums may also be eroded by the continued decline of physical CD sales. This is because, to date, growth in revenues from the sales of digital products has not offset the decline in revenues from the sale of physical products. For example, in 2006, although sales of digital albums and digital singles both grew by more than 50% compared to 2005, total revenues for the year fell by almost 9%. Unless the record companies can reduce their fixed costs in proportion to the decrease in total revenues, digital formats will have to bear an ever increasing proportion of the fixed costs necessary to run the music companies' operations, and margins for digital products will decline (and perhaps become negative) as a result.
8. If the compulsory mechanical royalty rate remains the same, copyright royalties will increase as a percentage of revenue during the shift to digital since mechanical royalties on digital products are not constrained by controlled composition clauses.
9. As I indicated above, the record companies earned a profit of a little more than \$.02 per song on each physical CD in 2006. I understand that the music publishers propose an increase in the royalty rate of \$.034 per song on physical CDs. As a matter of simple arithmetic, such an increase would render CDs unprofitable on average.
10. Combining the data for digital singles and digital albums, in 2006 the record companies earned a profit of a little more than \$.04 per digital song or track, after license fee allocations. (Before

license fee allocations, these tracks lost an average of 2 cents per track.) I understand that the music publishers propose an increase in the royalty rate of \$.059 per song in the royalty rate for permanent digital downloads. Again, simple arithmetic demonstrates that such an increase would render digital downloads unprofitable as well.

To explain how I reached these conclusions, I first describe the overall methodology used to construct financial profiles for each format followed by a brief analysis of the economic performance of the major recorded music formats. The last section of this testimony will briefly address two forecasts previously submitted in this matter. Since those forecasts have projected sales but not profitability, a complete depiction of their economic implications has not been provided to the Court, and I will attempt to do so in the final section.

IV. Methodology

The analysis reported in this testimony extends some work that was performed by FTI prior to the time it was engaged in this matter. FTI had previously released a white paper⁵ explaining how the transition to digital music was not a panacea for the record companies because margins on digital products were not sufficient to make up for the decline in physical sales. That analysis, performed by my group at FTI, was based on publicly available information about the record industry.

In order to further develop the foregoing analysis for this proceeding, I obtained a combination of public information and internal financial information for the major recorded music companies in the United States ("the Majors"). Using that information, I took the following basic steps:

Revenue and Units Sold

1. I began with Linda McLaughlin's consolidated financials for the major U.S. recorded music companies,⁶ updated them to include data for 2006, and adjusted the numbers based on updated financial statements provided by UMG, WMG and Sony BMG. (See Appendix A for a reconciliation.) All other data compiled by McLaughlin were left untouched. Figure 1, below on page 8, shows the results.

⁵ FTI Communications, Media and Entertainment, Summer 2007, *Industry Brief: The Music Industry at a Tipping Point* (RIAA Exhibit 123-RP)

⁶ CO Trial Ex. 41 (RIAA0008423)

2. I next determined the market share of the Majors by taking the ratio of the Majors' revenue for each year and comparing it to the RIAA's wholesale revenue projections for the same year. The RIAA's projections are for the entire U.S. recorded music entire industry. In 2006, for example, the Majors' net sales were 75% of U.S. recorded wholesale music revenues, excluding license fees.
3. I then applied this percentage to the wholesale revenue by format as provided by RIAA to get the revenue by format for the Majors. (See Appendix B.)

To determine net units shipped by the Majors for each format, I divided the wholesale price per unit, using industry-wide data compiled by PWC,⁷ into the revenue by format to compute units shipped. As discussed below, I used the weighted average wholesale price for CD albums, not including direct and special markets.⁸ The estimated units shipped by the Majors by format are shown in Appendix B.

⁷ See note 3.

⁸ The RIAA annual reports give wholesale prices with and without direct and special markets. See 2006 book, p3; 2005 book, p3; 2004 book, p3; 2001 book, p14. The reason for excluding direct and special markets is that the U.S. Majors earn only licensing revenue from that market, not sales revenue. Because our model calculates net units by dividing net sales revenue earned in each format by the average wholesale price in that format, using a wholesale price that included these direct and special markets would skew the results.

Figure 1: Revenue & Expense of U.S. Majors

US Majors - Totals from 1999 to 2006

In \$US Millions									
	1999	2000	2001	2002	2003	2004	2005	2006	CAGR
Net Sales Revenue	5,916	5,583	5,268	5,214	4,835	5,157	5,220	4,847	-2.8%
Net License Income	526	564	564	520	570	624	630	490	-1.0%
Total Revenue	6,442	6,147	5,832	5,734	5,404	5,781	5,850	5,336	-2.7%
Mechanical Royalties	512	488	440	471	443	488	527	547	1.0%
Artist Royalties	1,228	1,148	1,078	1,209	1,061	1,217	1,229	1,104	-1.5%
Advances & Recording	412	331	277	350	459	304	234	246	-7.1%
Direct Marketing	1,094	1,119	1,153	997	832	766	843	824	-4.0%
Manufacturing	713	630	607	583	594	595	598	511	-4.6%
Distribution	816	745	741	695	628	652	601	563	-5.2%
Overhead	1,289	1,329	1,338	1,199	1,409	1,354	1,318	1,241	-0.5%
Total Costs	6,064	5,791	5,634	5,504	5,426	5,376	5,350	5,036	-2.6%
Operating profit	378	356	198	231	(22)	405	500	300	-3.2%
Operating Margin	5.9%	5.8%	3.4%	4.0%	-0.4%	7.0%	8.5%	5.6%	-0.6%
Operating profit on sales	(148)	(208)	(366)	(290)	(592)	(219)	(130)	(189)	3.6%
% Margin	-2.5%	-3.7%	-6.9%	-5.6%	-12.2%	-4.2%	-2.5%	-3.9%	6.6%

This procedure gives the revenue and units for each format, but not expenses. I next calculated the expenses for each of the different formats. For some types of expenses I apportioned the various expenses in McLaughlin's report⁹ to each format in proportion to the units sold of the total. For example, artist advances in 1999 totaled \$412 million. I multiplied this times 82%, which is the ratio of the songs sold in CD album format to the total songs sold in 1999. This calculation yielded \$341 million as the portion of artist advances attributable to CD albums in 1999. Consistent with the median number of songs per album in the PWC data, I apportioned costs per unit by converting all formats to the song level using 13 songs per album¹⁰ and 2 songs per physical single.

While this proration method is reasonable for some expenses such as direct marketing, overhead and artist advances, it is not appropriate for other expenses such as the mechanical royalty, manufacturing,

⁹ Ibid.

¹⁰ This is the figure calculated by Dr. Teece, as illustrated by RIAA0015005. It is also the figure used by one of the publishers' experts, Ms. Enders, in her report on Recorded Music and Music Publishing, March 2007. RIAA Trial Ex. 27 (CO02001066).

distribution and artist royalties. These expenses were treated differently for physical and digital formats, as follows:

- **Mechanical Royalty:** For physical units, I used the ratio of total units to each format's individual units, multiplied by the overall copyright expense. For digital I used the statutory rate per song effective in each year. This resulted in physical units with a lower copyright expense than digital units. This is as expected. Physical units historically have not been subject to the full statutory rate because of controlled composition clauses. Digital formats are paying the full rate because controlled composition clauses are inapplicable.
- **Manufacturing:** I assumed digital bore no manufacturing expense, although there are almost certainly some manufacturing costs associated with digital formats. Hence, the physical formats bore all manufacturing cost.
- **Distribution:** I estimate digital distribution expense at 10% of a digital format's revenue. This is based on a digital P&L provided by UMG,¹¹ which was [REDACTED], and EMI data,¹² which was [REDACTED]. This expense was prorated over the various digital formats in proportion to their songs sold relative to the total digital songs sold. Physical formats bore the rest of the distribution expense in a given year.
- **Artist Royalties:** Artist royalties are generally a function of wholesale revenues. Hence I prorated total artist royalties paid in a given year to each format based on each format's wholesale revenues as a proportion of total revenues.

Taken together, this process provided a complete breakdown of revenue, expense and net units sold for each format.

Licensing revenue required special treatment. Licensing revenue comes from two basic sources. First, domestic third parties such as record clubs pay a license fee for the use of a sound recording master in order to manufacture and distribute CDs to their members. These are known as "direct & special" markets. Second, foreign record companies license the sound recording masters in order to manufacture and distribute CDs outside of the United States. In both cases, the licensee, rather than the U.S. record com-

¹¹ RIAA0020100, page 1: Digital income = [REDACTED]; Digital distribution = [REDACTED]; thus the distribution cost is [REDACTED] of digital income.

¹² RIAA0045905.

pany, bears the cost of manufacturing and distributing the product, the associated overhead costs, and any additional expenses to market and promote the sales of its products. And, in both cases, the mechanical royalties are paid by the licensee, rather than the U.S. record company, in accordance with local statutes.

I have included licensing revenues in my analysis to give a balanced picture of format profitability. I have apportioned the total license fees to each music format based on the format's revenue as a proportion of total revenue. Had I omitted the license revenue, physical CDs would have been unprofitable, digital albums would have been even more unprofitable, and other formats would have been less profitable. I chose to include license income in my analysis because I assume that the record companies factor such potential license revenues into their investment decisions. However, a reasonable argument could be made that I should have excluded license income, because the music publishers receive a separate mechanical royalty payment from the licensee for any sound recordings sold by the licensee. In other words, sales by the licensees in effect are separate transactions that produce separate mechanical royalties for the music publishers,¹³ and arguably should not form any part of the calculus concerning the appropriate of the royalty rate to be paid by the record companies. Furthermore, the industry must continuously strive to make these formats profitable in their own right, as CD albums were prior to 2001.

The methodology outlined above gives a complete picture of revenue, expense and units sold by format for the Majors. As an example, Figure 2 below shows the result for CD albums:

Figure 2: CD Album Total Revenue & Expense (U.S Majors)

3b - CD Albums								
CD Albums	1999	2000	2001	2002	2003	2004	2005	2006
CD Album Revenue	\$5,303	\$5,206	\$4,990	\$5,006	\$4,605	\$4,805	\$4,375	\$3,839
Mechanical	\$424	\$430	\$403	\$439	\$416	\$448	\$426	\$408
Artist Royalty	\$1,101	\$1,071	\$1,021	\$1,161	\$1,011	\$1,134	\$1,030	\$875
Advances & Recording	\$341	\$292	\$253	\$326	\$431	\$280	\$198	\$198
Direct Marketing	\$906	\$986	\$1,055	\$931	\$782	\$708	\$712	\$665
Manufacturing	\$590	\$555	\$555	\$544	\$558	\$561	\$551	\$488
Distribution	\$676	\$657	\$678	\$649	\$590	\$606	\$510	\$459
Overhead	\$1,068	\$1,171	\$1,224	\$1,119	\$1,324	\$1,250	\$1,112	\$1,001
Total Cost	\$5,106	\$5,162	\$5,189	\$5,168	\$5,110	\$4,988	\$4,539	\$4,094
Operating Profit before Lic.	\$198	\$43	(\$199)	(\$163)	(\$505)	(\$183)	(\$164)	(\$255)
Licensing income	\$472	\$526	\$534	\$500	\$543	\$581	\$528	\$388
Operating Profit with Licensing	\$670	\$569	\$335	\$337	\$37	\$398	\$364	\$133

¹³Because the costs incurred by the licensees do not show up on the books of the record companies, I have not attempted to analyze whether sales by the licensees are profitable or not.

In this example, net wholesale revenues for CD albums are shown by year, followed by the expenses allocated to the CD format. Operating profit is shown as the difference between revenue and total costs. The apportionment of licensing revenue to the CD format is then shown followed by operating profit after licensing fees. This same format is used throughout this analysis.

Based on the methodology above, Figures 3, 4 and 5 show revenue, expense and units shipped for each format. Specifically, the figures show the following data:

- **Figure 3: Total Revenue & Expense by Format**
- **Figure 4: Revenue & Expense Per Song/Track by Format**
- **Figure 5: Expenses as a Percentage of Sales Revenue by Format**

Figures 3, 4, and 5 appear on the pages that follow.

Figure 3: Total Revenue & Expense by Format (US Majors - \$ millions)
(Figures 3b - 3i)

3a - Combined P&L								
Combined P&L (\$ millions)	1999	2000	2001	2002	2003	2004	2005	2006
Total Revenue	\$5,916	\$5,583	\$5,268	\$5,214	\$4,835	\$5,157	\$5,165	\$4,770
Mechanical	\$512	\$488	\$440	\$471	\$443	\$488	\$527	\$547
Artist Royalty	\$1,228	\$1,148	\$1,078	\$1,209	\$1,061	\$1,217	\$1,216	\$1,087
Advances & Recording	\$412	\$331	\$277	\$350	\$459	\$304	\$232	\$242
Direct Marketing	\$1,094	\$1,119	\$1,153	\$997	\$832	\$766	\$835	\$812
Manufacturing	\$713	\$630	\$607	\$583	\$594	\$595	\$598	\$511
Distribution	\$816	\$745	\$741	\$695	\$628	\$652	\$595	\$555
Overhead	\$1,289	\$1,329	\$1,338	\$1,199	\$1,409	\$1,354	\$1,305	\$1,223
Total Cost	\$6,064	\$5,791	\$5,634	\$5,504	\$5,426	\$5,376	\$5,309	\$4,977
Profit before Licensing	(\$148)	(\$208)	(\$366)	(\$290)	(\$592)	(\$219)	(\$144)	(\$207)
Licensing income	\$526	\$564	\$564	\$520	\$570	\$624	\$623	\$482
Profit with Licensing	\$378	\$356	\$198	\$231	(\$22)	\$405	\$479	\$274

Equal's Major Label P&L, less subscriptions

3b - CD Albums								
CD Albums	1999	2000	2001	2002	2003	2004	2005	2006
CD Album Revenue	\$5,303	\$5,206	\$4,990	\$5,006	\$4,605	\$4,805	\$4,375	\$3,839
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Operating Profit with Licensing	\$670	\$569	\$335	\$337	\$37	\$398	\$364	\$133

3c - Other Physical Formats								
Other Physical	1999	2000	2001	2002	2003	2004	2005	2006
Physical Revenue	\$612.0	\$377.0	\$278.2	\$208.4	\$229.9	\$258.5	\$371.4	\$188.9
Mechanical	88.0	57.9	37.5	31.5	27.0	27.2	36.3	19.4
Artist Royalty	127.0	77.6	56.9	48.3	50.5	61.0	87.5	43.0
Advances & Recording	70.8	39.3	23.6	23.3	27.9	17.0	16.8	9.4
Direct Marketing	188.0	132.7	98.4	66.6	50.7	42.9	60.5	31.5
Manufacturing	122.4	74.7	51.7	38.9	36.2	34.0	46.9	23.1
Distribution	140.3	88.4	63.2	46.4	38.2	36.7	43.8	22.1
Overhead	221.5	157.6	114.1	80.1	85.8	75.7	94.6	47.5
Total Cost	957.9	628.3	445.4	335.2	316.3	294.4	386.4	196.1
Operating Profit	(\$345.8)	(\$251.3)	(\$167.3)	(\$126.8)	(\$86.3)	(\$35.9)	(\$14.9)	(\$7.1)
Licensing income	54.4	38.1	29.8	20.8	27.1	31.3	44.8	19.1
Operating Profit with Licensing	(\$291.4)	(\$213.2)	(\$137.5)	(\$106.0)	(\$59.2)	(\$4.7)	\$29.9	\$11.9

*Includes CD singles, cassette, LP and other singles (assumes 2 songs per single)

3d - Digital Albums

Digital Album P&L*	1999	2000	2001	2002	2003	2004	2005	2006
Digital Album Revenue						\$24.4	\$73.0	\$142.1
Mechanical						3.6	11.2	24.4
Artist Royalty						5.8	17.2	32.4
Advances & Recording						1.9	4.3	9.8
Direct Marketing						4.7	15.5	32.8
Manufacturing						0.0	0.0	0.0
Distribution						2.8	10.3	21.0
Overhead						8.3	24.3	49.4
Total Cost						27.0	82.8	169.8
Operating Profit						(\$2.7)	(\$9.8)	(\$27.7)
Licensing income						2.9	8.8	14.3
Operating Profit with Licensing						\$0.3	(\$1.0)	(\$13.3)

Includes downloaded albums and kiosk albums

3e - Digital Singles

Digital Singles P&L*	1999	2000	2001	2002	2003	2004	2005	2006
Digital Singles Revenue						\$69.4	\$193.3	\$307.8
Mechanical						8.6	23.3	39.9
Artist Royalty						16.4	45.5	70.1
Advances & Recording						4.4	9.0	16.0
Direct Marketing						11.1	32.3	53.5
Manufacturing						0.0	0.0	0.0
Distribution						6.6	21.5	34.3
Overhead						19.5	50.5	80.6
Total Cost						66.5	182.2	294.5
Operating Profit						\$2.9	\$11.1	\$13.3
Licensing income						8.4	23.3	31.1
Operating Profit with Licensing						\$11.3	\$34.5	\$44.4

Includes downloaded singles and kiosk singles

3f - Ringtones & Ringbacks

Ringtone/back P&L	1999	2000	2001	2002	2003	2004	2005	2006
Ringtone/back Revenue							\$147.4	\$258.7
Mechanical							29.6	52.6
Artist Royalty							34.7	58.9
Advances & Recording							4.1	7.8
Direct Marketing							14.6	26.1
Manufacturing							0.0	0.0
Distribution							9.7	16.8
Overhead							22.9	39.4
Total Cost							115.7	201.6
Operating Profit							\$31.8	\$57.1
Licensing income							17.8	26.1
Operating Profit with Licensing							\$49.6	\$83.2

3g - Other Digital								
Other Digital P&L	1999	2000	2001	2002	2003	2004	2005	2006
Other Digital Revenue							\$4.4	\$32.9
Mechanical							0.3	2.4
Artist Royalty							1.0	7.5
Advances & Recording							0.1	1.0
Direct Marketing							0.4	3.2
Manufacturing							0.0	0.0
Distribution							0.3	2.1
Overhead							0.7	4.8
Total Cost							2.9	21.0
Operating Profit							\$1.5	\$12.0
Licensing income							0.5	3.3
Operating Profit with Licensing							\$2.1	\$15.3

* Includes other mobile revenues, audio streams and wallpaper. Does not include subscription revenues

3h - Total Physical								
Total Physical P&L	1999	2000	2001	2002	2003	2004	2005	2006
Total Revenue	\$5,915.5	\$5,582.6	\$5,268.0	\$5,213.9	\$4,834.6	\$5,063.6	\$4,746.4	\$4,028.4
Mechanical	512.0	488.4	440.2	470.9	442.6	475.5	462.5	427.7
Artist Royalty	1,227.5	1,148.5	1,077.9	1,208.9	1,061.4	1,195.3	1,117.9	917.7
Advances & Recording	411.8	331.4	276.6	349.5	458.6	297.4	214.7	207.9
Direct Marketing	1,094.0	1,118.9	1,153.3	997.4	832.4	750.6	772.2	696.3
Manufacturing	712.6	629.5	606.6	582.6	594.1	594.8	598.0	511.0
Distribution	816.3	745.3	741.3	695.1	628.0	642.9	553.5	481.2
Overhead	1,289.2	1,328.7	1,338.1	1,199.1	1,409.3	1,326.0	1,206.6	1,048.6
Total Cost	6,063.5	5,790.6	5,634.0	5,503.5	5,426.3	5,282.5	4,925.4	4,290.5
Operating Profit	(\$148.0)	(\$208.1)	(\$366.0)	(\$289.6)	(\$591.7)	(\$218.9)	(\$179.0)	(\$262.1)
Licensing income	526.2	564.4	563.9	520.4	569.8	612.3	572.6	406.9
Operating Profit with Licensing	\$378.2	\$356.3	\$197.9	\$230.8	(\$21.9)	\$393.4	\$393.6	\$144.8

3i - Total Digital								
Total Digital P&L*	1999	2000	2001	2002	2003	2004	2005	2006
Total Revenue						\$93.8	\$418.2	\$741.5
Mechanical						\$12.2	64.4	119.3
Artist Royalty						\$22.1	98.5	168.9
Advances & Recording						\$6.2	17.5	34.5
Direct Marketing						\$15.8	62.9	115.7
Manufacturing						\$0.0	0.0	0.0
Distribution						\$9.4	41.8	74.1
Overhead						\$27.8	98.4	174.2
Total Cost						\$93.6	383.5	686.8
Operating Profit						\$0.2	\$34.7	\$54.7
Licensing income						\$11.3	50.4	74.9
Operating Profit with Licensing						\$11.6	\$85.1	\$129.5

*Includes all digital including ringtones/backups, streaming EXCEPT subscriptions

Figure 4: Revenue & Expense per Song/Track

4a - Song Level Combined P&L - US Majors								
Combined P&L	1999	2000	2001	2002	2003	2004	2005	2006
Total Revenue	\$0.720	\$0.754	\$0.779	\$0.768	\$0.760	\$0.739	\$0.730	\$0.717
Mechanical	\$0.062	\$0.066	\$0.065	\$0.069	\$0.070	\$0.070	\$0.075	\$0.082
Artist Royalty	\$0.149	\$0.155	\$0.159	\$0.178	\$0.167	\$0.174	\$0.172	\$0.163
Advances & Recording	\$0.050	\$0.045	\$0.041	\$0.051	\$0.072	\$0.043	\$0.033	\$0.036
Direct Marketing	\$0.133	\$0.151	\$0.170	\$0.147	\$0.131	\$0.110	\$0.118	\$0.122
Manufacturing	\$0.087	\$0.085	\$0.090	\$0.086	\$0.093	\$0.085	\$0.085	\$0.077
Distribution	\$0.099	\$0.101	\$0.110	\$0.102	\$0.099	\$0.093	\$0.084	\$0.084
Overhead	\$0.157	\$0.179	\$0.198	\$0.177	\$0.222	\$0.194	\$0.185	\$0.184
Total Cost	\$0.738	\$0.782	\$0.833	\$0.811	\$0.853	\$0.770	\$0.751	\$0.749
Profit before Licensing	-\$0.018	-\$0.028	-\$0.054	-\$0.043	-\$0.093	-\$0.031	-\$0.020	-\$0.031
Licensing income	\$0.064	\$0.076	\$0.083	\$0.077	\$0.090	\$0.089	\$0.088	\$0.072
Profit with Licensing	\$0.046	\$0.048	\$0.029	\$0.034	-\$0.003	\$0.058	\$0.068	\$0.041
Songs (millions)	8218.0	7404.1	6766.7	6789.7	6361.5	6980.4	7070.1	6648.3

4b - Revenue & Expense per CD Album Songs								
CD Albums	1999	2000	2001	2002	2003	2004	2005	2006
CD Album Revenue	\$0.779	\$0.798	\$0.806	\$0.790	\$0.771	\$0.745	\$0.726	\$0.705
Mechanical	\$0.062	\$0.066	\$0.065	\$0.069	\$0.070	\$0.070	\$0.071	\$0.075
Artist Royalty	\$0.162	\$0.164	\$0.165	\$0.183	\$0.169	\$0.176	\$0.171	\$0.161
Advances & Recording	\$0.050	\$0.045	\$0.041	\$0.051	\$0.072	\$0.043	\$0.033	\$0.036
Direct Marketing	\$0.133	\$0.151	\$0.170	\$0.147	\$0.131	\$0.110	\$0.118	\$0.122
Manufacturing	\$0.087	\$0.085	\$0.090	\$0.086	\$0.093	\$0.087	\$0.091	\$0.090
Distribution	\$0.099	\$0.101	\$0.110	\$0.102	\$0.099	\$0.094	\$0.085	\$0.084
Overhead	\$0.157	\$0.179	\$0.198	\$0.177	\$0.222	\$0.194	\$0.185	\$0.184
Total Cost	\$0.750	\$0.791	\$0.838	\$0.816	\$0.855	\$0.774	\$0.753	\$0.752
Operating Profit	\$0.029	\$0.007	(\$0.032)	(\$0.026)	(\$0.085)	(\$0.028)	(\$0.027)	(\$0.047)
Licensing income	\$0.069	\$0.081	\$0.086	\$0.079	\$0.091	\$0.090	\$0.088	\$0.071
Operating Profit with Licensing	\$0.098	\$0.087	\$0.054	\$0.053	\$0.006	\$0.062	\$0.060	\$0.024
Songs within CD albums (mm's)	6806.0	6525.8	6189.7	6336.1	5974.1	6446.5	6024.8	5443.0

4c - Revenue & Expense per Song - Other Physical Format								
Other Physical	1999	2000	2001	2002	2003	2004	2005	2006
Other Physical Revenue	\$0.433	\$0.429	\$0.482	\$0.460	\$0.594	\$0.662	\$0.725	\$0.732
Mechanical	\$0.062	\$0.066	\$0.065	\$0.069	\$0.070	\$0.070	\$0.071	\$0.075
Artist Royalty	\$0.090	\$0.088	\$0.099	\$0.107	\$0.130	\$0.156	\$0.171	\$0.167
Advances & Recording	\$0.050	\$0.045	\$0.041	\$0.051	\$0.072	\$0.043	\$0.033	\$0.036
Direct Marketing	\$0.133	\$0.151	\$0.170	\$0.147	\$0.131	\$0.110	\$0.118	\$0.122
Manufacturing	\$0.087	\$0.085	\$0.090	\$0.086	\$0.093	\$0.087	\$0.091	\$0.090
Distribution	\$0.099	\$0.101	\$0.110	\$0.102	\$0.099	\$0.094	\$0.086	\$0.086
Overhead	\$0.157	\$0.179	\$0.198	\$0.177	\$0.222	\$0.194	\$0.185	\$0.184
Total Cost	\$0.678	\$0.715	\$0.772	\$0.739	\$0.816	\$0.754	\$0.754	\$0.760
Operating Profit	(\$0.245)	(\$0.286)	(\$0.290)	(\$0.280)	(\$0.223)	(\$0.092)	(\$0.029)	(\$0.028)
Licensing income	\$0.039	\$0.043	\$0.052	\$0.046	\$0.070	\$0.080	\$0.087	\$0.074
Operating Profit with Licensing	(\$0.206)	(\$0.243)	(\$0.238)	(\$0.234)	(\$0.153)	(\$0.012)	\$0.058	\$0.046
Songs (millions)	1411.9	878.4	577.0	453.6	387.4	390.4	512.4	258.1

4d - Digital Album - Song Revenue & Expense								
Digital Album P&L	1999	2000	2001	2002	2003	2004	2005	2006
Revenue						\$0.570	\$0.555	\$0.529
Mechanical						\$0.085	\$0.085	\$0.091
Artist Royalty						\$0.135	\$0.131	\$0.121
Advances & Recording						\$0.043	\$0.033	\$0.036
Direct Marketing						\$0.110	\$0.118	\$0.122
Manufacturing						\$0.000	\$0.000	\$0.000
Distribution						\$0.065	\$0.078	\$0.078
Overhead						\$0.194	\$0.185	\$0.184
Total Cost						\$0.632	\$0.630	\$0.632
Operating Profit						(\$0.062)	(\$0.074)	(\$0.103)
Licensing income						\$0.069	\$0.067	\$0.053
Operating Profit with Licensing						\$0.007	(\$0.008)	(\$0.050)
Songs within downloaded albums (millions)						42.8	131.5	268.4

4e - Digital Singles - Song Level P&L								
Digital Singles	1999	2000	2001	2002	2003	2004	2005	2006
Revenue						\$0.689	\$0.706	\$0.702
Mechanical						\$0.085	\$0.085	\$0.091
Artist Royalty						\$0.163	\$0.166	\$0.160
Advances & Recording						\$0.043	\$0.033	\$0.036
Direct Marketing						\$0.110	\$0.118	\$0.122
Manufacturing						\$0.000	\$0.000	\$0.000
Distribution						\$0.065	\$0.078	\$0.078
Overhead						\$0.194	\$0.185	\$0.184
Total Cost						\$0.660	\$0.665	\$0.672
Operating Profit						\$0.029	\$0.041	\$0.030
Licensing income						\$0.083	\$0.085	\$0.071
Operating Profit with Licensing						\$0.112	\$0.126	\$0.101
Downloaded Songs (millions)						100.8	273.8	438.4

4f - Revenue & Expense per Ringtone								
Ringtone/back P&L	1999	2000	2001	2002	2003	2004	2005	2006
Revenue							\$1.190	\$1.209
Mechanical							\$0.239	\$0.246
Artist Royalty							\$0.280	\$0.275
Advances & Recording							\$0.033	\$0.036
Direct Marketing							\$0.118	\$0.122
Manufacturing							\$0.000	\$0.000
Distribution							\$0.078	\$0.078
Overhead							\$0.185	\$0.184
Total Cost							\$0.933	\$0.942
Operating Profit							\$0.256	\$0.267
Licensing income							\$0.144	\$0.122
Operating Profit with Licensing							\$0.400	\$0.389
Songs (millions)							123.9	214.1

4g - Other Digital Revenue & Expense per Song								
Other Digital P&L	1999	2000	2001	2002	2003	2004	2005	2006
Other Digital Revenue							\$1.202	\$1.252
Mechanical							\$0.085	\$0.091
Artist Royalty							\$0.283	\$0.285
Advances & Recording							\$0.033	\$0.036
Direct Marketing							\$0.118	\$0.122
Manufacturing							\$0.000	\$0.000
Distribution							\$0.078	\$0.078
Overhead							\$0.185	\$0.184
Total Cost							\$0.782	\$0.797
Operating Profit							\$0.420	\$0.455
Licensing income							\$0.145	\$0.126
Operating Profit with Licensing							\$0.565	\$0.581
Songs (millions)							3.7	26.3

4h - Total Physical - Song Level								
Physical Song P&L	1999	2000	2001	2002	2003	2004	2005	2006
Total Revenue	\$0.720	\$0.754	\$0.779	\$0.768	\$0.760	\$0.741	\$0.726	\$0.707
Mechanical	\$0.062	\$0.066	\$0.065	\$0.069	\$0.070	\$0.070	\$0.071	\$0.075
Artist Royalty	\$0.149	\$0.155	\$0.159	\$0.178	\$0.167	\$0.175	\$0.171	\$0.161
Advances & Recording	\$0.050	\$0.045	\$0.041	\$0.051	\$0.072	\$0.043	\$0.033	\$0.036
Direct Marketing	\$0.133	\$0.151	\$0.170	\$0.147	\$0.131	\$0.110	\$0.118	\$0.122
Manufacturing	\$0.087	\$0.085	\$0.090	\$0.086	\$0.093	\$0.087	\$0.091	\$0.090
Distribution	\$0.099	\$0.101	\$0.110	\$0.102	\$0.099	\$0.094	\$0.085	\$0.084
Overhead	\$0.157	\$0.179	\$0.198	\$0.177	\$0.222	\$0.194	\$0.185	\$0.184
Total Cost	\$0.738	\$0.782	\$0.833	\$0.811	\$0.853	\$0.773	\$0.753	\$0.753
Operating Profit	(\$0.018)	(\$0.028)	(\$0.054)	(\$0.043)	(\$0.093)	(\$0.032)	(\$0.027)	(\$0.046)
Licensing income	\$0.064	\$0.076	\$0.083	\$0.077	\$0.090	\$0.090	\$0.088	\$0.071
Operating Profit with Licensing	\$0.046	\$0.048	\$0.029	\$0.034	(\$0.003)	\$0.058	\$0.060	\$0.025
Physical songs (millions)	8217.996	7404.148	6766.713	6789.664	6361.481	6836.888	6537.2	5701.1

4i - Total Digital at Song Level								
Digital Song P&L	1999	2000	2001	2002	2003	2004	2005	2006
Total Revenue						\$0.654	\$0.662	\$0.659
Mechanical						\$0.085	\$0.085	\$0.091
Artist Royalty						\$0.154	\$0.156	\$0.150
Advances & Recording						\$0.043	\$0.033	\$0.036
Direct Marketing						\$0.110	\$0.118	\$0.122
Manufacturing						\$0.000	\$0.000	\$0.000
Distribution						\$0.065	\$0.078	\$0.078
Overhead						\$0.194	\$0.185	\$0.184
Total Cost						\$0.652	\$0.655	\$0.662
Operating Profit						\$0.002	\$0.007	(\$0.003)
Licensing income						\$0.079	\$0.123	\$0.102
Operating Profit with Licensing						\$0.081	\$0.130	\$0.099
Digital Songs (Millions)						143.6	409.0	733.1

Figure 5: Economic Performance of Music Formats as Percent of Revenue

5a - Music Labels Revenue & Expense as % of Revenue								
Total % of Revenue	1999	2000	2001	2002	2003	2004	2005	2006
Total Revenue	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Mechanical	8.7%	8.7%	8.4%	9.0%	9.2%	9.5%	10.2%	11.5%
Artist Royalty	20.8%	20.6%	20.5%	23.2%	22.0%	23.6%	23.6%	22.8%
Advances & Recording	7.0%	5.9%	5.3%	6.7%	9.5%	5.9%	4.5%	5.1%
Direct Marketing	18.5%	20.0%	21.9%	19.1%	17.2%	14.9%	16.2%	17.0%
Manufacturing	12.0%	11.3%	11.5%	11.2%	12.3%	11.5%	11.6%	10.7%
Distribution	13.8%	13.4%	14.1%	13.3%	13.0%	12.6%	11.5%	11.6%
Overhead	21.8%	23.8%	25.4%	23.0%	29.2%	26.2%	25.3%	25.6%
Total Cost	102.5%	103.7%	106.9%	105.6%	112.2%	104.2%	102.8%	104.4%
Profit before Licensing	-2.5%	-3.7%	-6.9%	-5.6%	-12.2%	-4.2%	-2.8%	-4.4%
Licensing income	8.9%	10.1%	10.7%	10.0%	11.8%	12.1%	12.1%	10.1%
Profit with Licensing	6.4%	6.4%	3.8%	4.4%	-0.5%	7.9%	9.3%	5.8%

5b - CD Albums Revenue & Expense as Percent of Revenue								
CD Albums % of Revenue	1999	2000	2001	2002	2003	2004	2005	2006
CD Album Revenue	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Mechanical	8.0%	8.3%	8.1%	8.8%	9.0%	9.3%	9.7%	10.6%
Artist Royalty	20.8%	20.6%	20.5%	23.2%	22.0%	23.6%	23.6%	22.8%
Advances & Recording	6.4%	5.6%	5.1%	6.5%	9.4%	5.8%	4.5%	5.2%
Direct Marketing	17.1%	18.9%	21.1%	18.6%	17.0%	14.7%	16.3%	17.3%
Manufacturing	11.1%	10.7%	11.1%	10.9%	12.1%	11.7%	12.6%	12.7%
Distribution	12.7%	12.6%	13.6%	13.0%	12.8%	12.6%	11.7%	12.0%
Overhead	20.1%	22.5%	24.5%	22.4%	28.7%	26.0%	25.4%	26.1%
Total Cost	96.3%	99.2%	104.0%	103.3%	111.0%	103.8%	103.8%	106.6%
Operating Profit	3.7%	0.8%	-4.0%	-3.3%	-11.0%	-3.8%	-3.8%	-6.6%
Licensing income	8.9%	10.1%	10.7%	10.0%	11.8%	12.1%	12.1%	10.1%
Operating Profit with Licensing	12.6%	10.9%	6.7%	6.7%	0.8%	8.3%	8.3%	3.5%

5c - Other Physical - Percent of Revenue								
Other Phys. % of Rev.	1999	2000	2001	2002	2003	2004	2005	2006
Other Physical Revenue	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Mechanical	14.4%	15.4%	13.5%	15.1%	11.7%	10.5%	9.8%	10.2%
Artist Royalty	20.8%	20.6%	20.5%	23.2%	22.0%	23.6%	23.6%	22.8%
Advances & Recording	11.6%	10.4%	8.5%	11.2%	12.1%	6.6%	4.5%	5.0%
Direct Marketing	30.7%	35.2%	35.4%	32.0%	22.0%	16.6%	16.3%	16.7%
Manufacturing	20.0%	19.8%	18.6%	18.7%	15.7%	13.1%	12.6%	12.2%
Distribution	22.9%	23.5%	22.7%	22.3%	16.6%	14.2%	11.8%	11.7%
Overhead	36.2%	41.8%	41.0%	38.4%	37.3%	29.3%	25.5%	25.1%
Total Cost	156.5%	166.7%	160.1%	160.8%	137.5%	113.9%	104.0%	103.8%
Operating Profit	-56.5%	-66.7%	-60.1%	-60.8%	-37.5%	-13.9%	-4.0%	-3.8%
Licensing income	8.9%	10.1%	10.7%	10.0%	11.8%	12.1%	12.1%	10.1%
Operating Profit with Licensing	-47.6%	-56.5%	-49.4%	-50.9%	-25.8%	-1.8%	8.0%	6.3%

5d - Digital Albums Expense as % of Revenue								
Dig. Album % of Rev.	1999	2000	2001	2002	2003	2004	2005	2006
Revenue						100.0%	100.0%	100.0%
Mechanical						14.9%	15.3%	17.2%
Artist Royalty						23.6%	23.6%	22.8%
Advances & Recording						7.6%	5.9%	6.9%
Direct Marketing						19.3%	21.3%	23.1%
Manufacturing						0.0%	0.0%	0.0%
Distribution						11.5%	14.1%	14.8%
Overhead						34.0%	33.2%	34.8%
Total Cost						110.9%	113.4%	119.5%
Operating Profit						-10.9%	-13.4%	-19.5%
Licensing income						12.1%	12.1%	10.1%
Operating Profit with Licensing						1.2%	-1.4%	-9.4%

5e - Digital Singles Expense as % of Revenue								
Digital Single % of Rev.	1999	2000	2001	2002	2003	2004	2005	2006
Revenue						100.0%	100.0%	100.0%
Mechanical						12.3%	12.0%	13.0%
Artist Royalty						23.6%	23.6%	22.8%
Advances & Recording						6.3%	4.7%	5.2%
Direct Marketing						15.9%	16.7%	17.4%
Manufacturing						0.0%	0.0%	0.0%
Distribution						9.5%	11.1%	11.1%
Overhead						28.1%	26.1%	26.2%
Total Cost						95.8%	94.2%	95.7%
Operating Profit						4.2%	5.8%	4.3%
Licensing income						12.1%	12.1%	10.1%
Operating Profit with Licensing						16.3%	17.8%	14.4%

5f - Ringtones/Ringbacks - Expense as % of Revenue								
Ringtone/back % of Rev.	1999	2000	2001	2002	2003	2004	2005	2006
Revenue							100.0%	100.0%
Mechanical							20.1%	20.3%
Artist Royalty							23.6%	22.8%
Advances & Recording							2.8%	3.0%
Direct Marketing							9.9%	10.1%
Manufacturing							0.0%	0.0%
Distribution							6.6%	6.5%
Overhead							15.5%	15.2%
Total Cost							78.5%	77.9%
Operating Profit							21.5%	22.1%
Licensing income							12.1%	10.1%
Operating Profit with Licensing							33.6%	32.2%

5g - Other Digital - Expenses as % of Revenue								
Other Digital % of Rev.	1999	2000	2001	2002	2003	2004	2005	2006
Other Digital Revenue							100.0%	100.0%
Mechanical							7.1%	7.3%
Artist Royalty							23.6%	22.8%
Advances & Recording							2.7%	2.9%
Direct Marketing							9.8%	9.8%
Manufacturing							0.0%	0.0%
Distribution							6.5%	6.3%
Overhead							15.4%	14.7%
Total Cost							65.1%	63.7%
Operating Profit							34.9%	36.3%
Licensing income							12.1%	10.1%
Operating Profit with Licensing							47.0%	46.4%

5h - Total Physical - Expenses as % of Revenue								
Physical % of Rev.	1999	2000	2001	2002	2003	2004	2005	2006
Total Revenue	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Mechanical	8.7%	8.7%	8.4%	9.0%	9.2%	9.4%	9.7%	10.6%
Artist Royalty	20.8%	20.6%	20.5%	23.2%	22.0%	23.6%	23.6%	22.8%
Advances & Recording	7.0%	5.9%	5.3%	6.7%	9.5%	5.9%	4.5%	5.2%
Direct Marketing	18.5%	20.0%	21.9%	19.1%	17.2%	14.8%	16.3%	17.3%
Manufacturing	12.0%	11.3%	11.5%	11.2%	12.3%	11.7%	12.6%	12.7%
Distribution	13.8%	13.4%	14.1%	13.3%	13.0%	12.7%	11.7%	11.9%
Overhead	21.8%	23.8%	25.4%	23.0%	29.2%	26.2%	25.4%	26.0%
Total Cost	102.5%	103.7%	106.9%	105.6%	112.2%	104.3%	103.8%	106.5%
Operating Profit	-2.5%	-3.7%	-6.9%	-5.6%	-12.2%	-4.3%	-3.8%	-6.5%
Licensing income	8.9%	10.1%	10.7%	10.0%	11.8%	12.1%	12.1%	10.1%
Operating Profit with Licensing	6.4%	6.4%	3.8%	4.4%	-0.5%	7.8%	8.3%	3.6%

5i - Total Digital - Expenses as % of Revenue								
Digital % of Rev.	1999	2000	2001	2002	2003	2004	2005	2006
Total Revenue						100.0%	100.0%	100.0%
Mechanical						13.0%	12.8%	13.8%
Artist Royalty						23.6%	23.6%	22.8%
Advances & Recording						6.7%	5.0%	5.5%
Direct Marketing						16.8%	17.8%	18.5%
Manufacturing						0.0%	0.0%	0.0%
Distribution						10.0%	11.9%	11.9%
Overhead						29.7%	27.9%	27.9%
Total Cost						99.7%	98.9%	100.5%
Operating Profit						0.3%	1.1%	-0.5%
Licensing income						12.1%	18.6%	15.5%
Operating Profit with Licensing						12.3%	19.7%	15.0%

V. Financial Performance of the Major Music Formats

A. Overall Performance

As shown in Figure 1, between 1999 and 2006 the Majors' revenues have steadily declined. Sales revenues have dropped by more than a billion dollars from \$5.9 billion to \$4.8 billion. During that same time period, the Majors reduced every category of costs, with one exception, in order to preserve modest profit margins. Cost-cutting allowed the record companies to earn an overall margin of 5.6% in 2006, although the margin on sales before license income was negative 3.9%. The one category of costs which has not declined is mechanical royalties, which increased from 1999 to 2006 in both absolute terms and as a percentage of revenue. Certain other costs, such as overhead and artist royalties, have increased as a percentage of revenue (due to the fact that revenues are dropping faster than these costs have been reduced), but overhead and artist royalties decreased in absolute terms. See Figure 1. Only the mechanical royalty costs have increased in absolute terms.

It is instructive to view these results at the song level, as shown in Figure 4a and reprinted below. Song-level results are derived by dividing the financial results shown in Figure 3a by the total number of songs (sometimes referred to as "tracks") sold each year.¹⁴ (The chart does not include subscriptions, which are not material.)

Figure 4a (reprinted from p. 15)

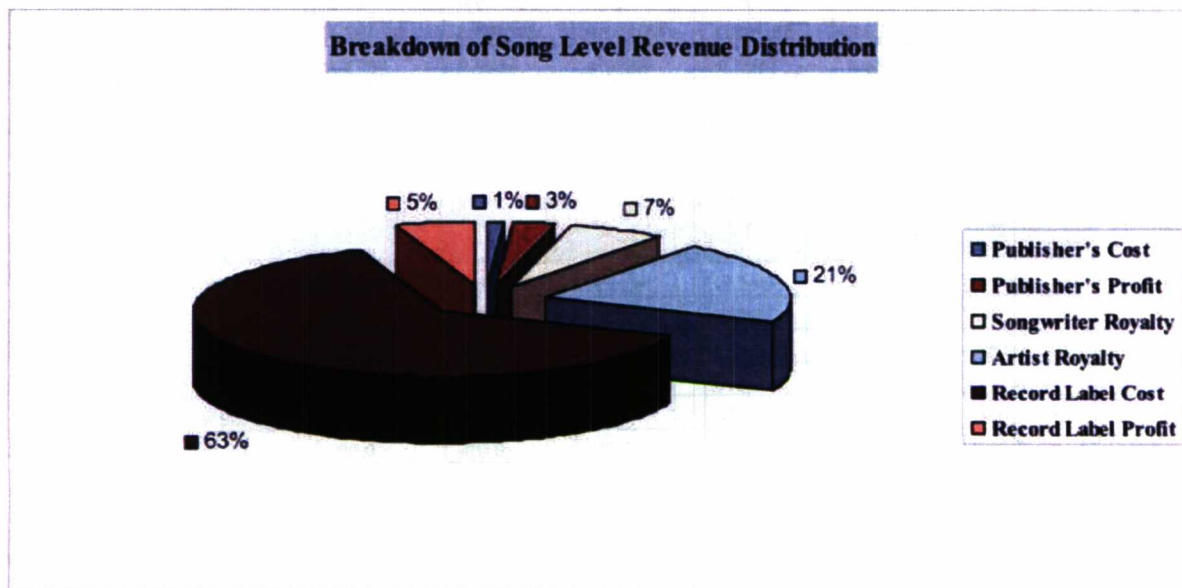
4a - Song Level Combined P&L - US Majors								
Combined P&L	1999	2000	2001	2002	2003	2004	2005	2006
Total Revenue	\$0.720	\$0.754	\$0.779	\$0.768	\$0.760	\$0.739	\$0.730	\$0.717
Mechanical	\$0.062	\$0.066	\$0.065	\$0.069	\$0.070	\$0.070	\$0.075	\$0.082
Artist Royalty	\$0.149	\$0.155	\$0.159	\$0.178	\$0.167	\$0.174	\$0.172	\$0.163
Advances & Recording	\$0.050	\$0.045	\$0.041	\$0.051	\$0.072	\$0.043	\$0.033	\$0.036
Direct Marketing	\$0.133	\$0.151	\$0.170	\$0.147	\$0.131	\$0.110	\$0.118	\$0.122
Manufacturing	\$0.087	\$0.085	\$0.090	\$0.086	\$0.093	\$0.085	\$0.085	\$0.077
Distribution	\$0.099	\$0.101	\$0.110	\$0.102	\$0.099	\$0.093	\$0.084	\$0.084
Overhead	\$0.157	\$0.179	\$0.198	\$0.177	\$0.222	\$0.194	\$0.185	\$0.184
Total Cost	\$0.738	\$0.782	\$0.833	\$0.811	\$0.853	\$0.770	\$0.751	\$0.749
Profit before Licensing	-\$0.018	-\$0.028	-\$0.054	-\$0.043	-\$0.093	-\$0.031	-\$0.020	-\$0.031
Licensing income	\$0.064	\$0.076	\$0.083	\$0.077	\$0.090	\$0.089	\$0.088	\$0.072
Profit with Licensing	\$0.046	\$0.048	\$0.029	\$0.034	-\$0.003	\$0.058	\$0.068	\$0.041
Songs (millions)	8218.0	7404.1	6766.7	6789.7	6361.5	6980.4	7070.1	6648.3

¹⁴ To calculate the number of songs sold in a year, CD albums and digital albums were estimated to contain 13 songs per album. See note 10.

Although one might expect wholesale prices to increase as a result of inflation, the aggregate average revenue per song has declined from a high of 78 cents in 2001 to 72 cents in 2006.

These results are depicted below in a chart which shows how the average total revenue per song is distributed between record company costs and profits, publisher costs and profits,¹⁵ and payments to songwriters and artists.

Figure 6: Breakdown of Song Level Revenue Distribution (Restricted)



Turning to the revenue contribution of each format, Figure 7 on the following page shows revenue by format both in dollars and as a percent of net sales.

¹⁵ In order to calculate the figures in this chart, I used the figures in Table A to the testimony of Terri Santisi to calculate the amount of publisher revenue that went to songwriters -- ie., the cost of goods sold -- as a percentage of revenues. I then calculated the percentage of publisher revenues attributable to overhead/expenses and the percentage attributable to profit in the same manner. I did this for all four major publishers for which Table A reported data on US revenues and expenditures -- BMG MP, EMI MP, Sony/ATV, and UMPG. (In the case of UMPG, Table A did not provide actual figures on revenues and expenses for 2006. Accordingly, I used midyear forecast data contained at CO09008404.) Using a weighted average across these four major publishers, I then determined the average amounts that the publishers spent on songwriter royalties and overhead expenses, as well as the amount they retained in profits, for each \$0.082 that they earned in revenues.

Figure 7: Total Revenue by Format

Revenue by Format									
Revenue by Format	1999	2000	2001	2002	2003	2004	2005	2006	CAGR
CD Album	\$5,303.5	\$5,205.6	\$4,989.8	\$5,005.5	\$4,604.7	\$4,805.1	\$4,374.9	\$3,839.4	-4.5%
Other Physical	\$612.0	\$377.0	\$278.2	\$208.4	\$229.9	\$258.5	\$371.4	\$188.9	-15.5%
Digital Album	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$24.4	\$73.0	\$142.1	141.4%
Digital Single	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$69.4	\$193.3	\$307.8	110.5%
Ringtones/Backs	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$147.4	\$258.7	75.5%
Other Digital	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$4.4	\$32.9	644.8%
Total Net Sales	\$5,915.5	\$5,582.6	\$5,268.0	\$5,213.9	\$4,834.6	\$5,157.4	\$5,164.6	\$4,769.9	-3.0%
License Income	\$526.2	\$564.4	\$563.9	\$520.4	\$569.8	\$623.7	\$629.7	\$489.6	-1.0%
Total Operating Revenue	\$6,441.7	\$6,147.0	\$5,831.9	\$5,734.4	\$5,404.4	\$5,781.1	\$5,794.3	\$5,259.4	-2.9%

* Does not include subscription Revenue, which is not material

% of Net Sales Revenue by Format								
% of Net Sales	1999	2000	2001	2002	2003	2004	2005	2006
CD Album	89.7%	93.2%	94.7%	96.0%	95.2%	93.2%	84.7%	80.5%
Other Physical	10.3%	6.8%	5.3%	4.0%	4.8%	5.0%	7.2%	4.0%
Digital Album	0.0%	0.0%	0.0%	0.0%	0.0%	0.5%	1.4%	3.0%
Digital Single	0.0%	0.0%	0.0%	0.0%	0.0%	1.3%	3.7%	6.5%
Ringtones/Backs	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	2.9%	5.4%
Other Digital	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.7%
Income from Sales	100%	100%	100%	100%	100%	100%	100%	100%

* Does not include subscription Revenue, which are not material

Based on the second chart above, CD album revenue is still the dominant revenue source for the Majors, generating almost 90% of net sales in 1999, declining to 80% by 2006. Digital song and album downloading have more than quadrupled from \$93.8 million in 2004 to \$449.9 million in 2006. Taken together, digital albums and digital singles accounted for roughly 9.5% of sales revenue. Ringtones and ringbacks accounted for 5.4% of sales in 2006.

The remainder of this section analyzes the financial profile of each of the major formats. This includes CD albums, digital albums and ringtones. I have not included a detailed analysis of digital music videos and wallpaper because they are less than 1% of overall revenues.

B. CD Albums

As previously shown in Figure 2, total CD album revenue for the Majors declined from \$5.3 billion in 1999 to \$3.8 billion in 2006. When licensing revenue is included, total profits generated by the CD album

format declined from \$670 million in 1999 to \$133 million in 2006. Before licensing revenue, the CD format has been unprofitable since 2001. As the chart on the next page shows, at the album level, the profitability of each CD has declined significantly since 1999. Wholesale prices for CDs have steadily declined since 2001, while mechanical royalties have risen.

Figure 8: CD Album Level Revenue & Expense

CD Album - Revenue & Expense								
CD Albums	1999	2000	2001	2002	2003	2004	2005	2006
Total Revenue	\$10.13	\$10.37	\$10.48	\$10.27	\$10.02	\$9.69	\$9.44	\$9.17
Mechanical	0.81	0.86	0.85	0.90	0.90	0.90	0.92	0.98
Artist Royalty	2.10	2.13	2.14	2.38	2.20	2.29	2.22	2.09
Advances & Recording	0.65	0.58	0.53	0.67	0.94	0.57	0.43	0.47
Direct Marketing	1.73	1.96	2.22	1.91	1.70	1.43	1.54	1.59
Manufacturing	1.13	1.11	1.17	1.12	1.21	1.13	1.19	1.17
Distribution	1.29	1.31	1.42	1.33	1.28	1.22	1.10	1.10
Overhead	2.04	2.33	2.57	2.30	2.88	2.52	2.40	2.39
Total Cost	9.75	10.28	10.90	10.60	11.12	10.06	9.79	9.78
Operating Profit	\$0.38	\$0.09	(\$0.42)	(\$0.33)	(\$1.10)	(\$0.37)	(\$0.35)	(\$0.61)
Licensing income	0.90	1.05	1.12	1.03	1.18	1.17	1.14	0.93
Operating Profit with Licensing	\$1.28	\$1.13	\$0.70	\$0.69	\$0.08	\$0.80	\$0.78	\$0.32
CD Albums	523.5	502.0	476.1	487.4	459.5	495.9	463.4	418.7

C. Digital Albums

Figure 7 above shows digital albums accounted for only 3% of 2006 sales but are growing quickly at an annual growth rate of 141%. However, they are not profitable even after licensing fees. (See Figure 3d.) If the 418 million CDs sold in 2006 were eventually replaced by digital albums, the Majors would lose \$560 million in operating profit before license fees and would lose \$272 million after licensing fees. The chart below shows the economic performance of digital albums at the album level:

Figure 9: Digital Album Level Revenue & Expense

Digital Albums - Album Level Revenue & Expense								
Digital Albums	1999	2000	2001	2002	2003	2004	2005	2006
Total Revenue						\$7.41	\$7.22	\$6.88
Mechanical						1.11	1.11	1.18
Artist Royalty						1.75	1.70	1.57
Advances & Recording						0.57	0.43	0.47
Direct Marketing						1.43	1.54	1.59
Manufacturing						0.00	0.00	0.00
Distribution						0.85	1.02	1.02
Overhead						2.52	2.40	2.39
Total Cost						8.22	8.19	8.22
Operating Profit						(\$0.81)	(\$0.97)	(\$1.341)
Licensing income						0.90	0.87	0.69
Operating Profit with Licensing						\$0.09	(\$0.10)	(\$0.65)
Albums (millions)						3.3	10.1	20.6

Digital albums are unprofitable in part because wholesale prices are significantly less than the wholesale prices for CDs, and have been declining, while mechanical copyright royalties are greater than mechanical royalties for CDs (due to the preemption of controlled composition clauses) and have been increasing. The wholesale price declined from \$7.41 in 2004 to \$6.88 cents in 2006. Mechanical royalties increased by 7 cents for the album (because of a statutory increase of 0.6 cents per song between 2005 and 2006). This, taken together with the declining wholesale price, has undermined digital album profitability.

D. Digital Singles

The financial profile of digital singles is shown below, as reprinted from Figure 4e on page 16. My analysis indicates that digital songs earn about 10 cents per song after allocation of their share of licensing revenue.

Figure 4e (reprinted from p. 16) : Digital Singles Song Level Revenue & Expense

4e - Digital Singles - Song Level P&L								
Digital Singles	1999	2000	2001	2002	2003	2004	2005	2006
Revenue						\$0.689	\$0.706	\$0.702
Mechanical						\$0.085	\$0.085	\$0.091
Artist Royalty						\$0.163	\$0.166	\$0.160
Advances & Recording						\$0.043	\$0.033	\$0.036
Direct Marketing						\$0.110	\$0.118	\$0.122
Manufacturing						\$0.000	\$0.000	\$0.000
Distribution						\$0.065	\$0.078	\$0.078
Overhead						\$0.194	\$0.185	\$0.184
Total Cost						\$0.660	\$0.665	\$0.672
Operating Profit						\$0.029	\$0.041	\$0.030
Licensing income						\$0.083	\$0.085	\$0.071
Operating Profit with Licensing						\$0.112	\$0.126	\$0.101
Downloaded Songs (millions)						100.8	273.8	438.4

The copyright rate is shown as increasing in accordance with statute from 8.5 cents per song to 9.1 cents per song. I have assumed that digital incurs no manufacturing costs, and I have estimated digital distribution costs at 10% of revenue as discussed on page 9. This reflects the expenses needed to support digital distribution. This 10% for digital is lower than the overall average distribution percentage of 11.6% (see Figure 5a) for the Majors.

E. Ringtones and Ringbacks

Ringtones and ringbacks have a completely different financial profile than songs and albums and serve a different consumer need. These mobile formats are profitable, as shown in Figure 4f and reprinted on the following page:

Figure 4f (reprinted from p. 16)

4f - Revenue & Expense per Ringtone								
Ringtone/back P&L	1999	2000	2001	2002	2003	2004	2005	2006
Revenue							\$1.190	\$1.209
Mechanical							\$0.239	\$0.246
Artist Royalty							\$0.280	\$0.275
Advances & Recording							\$0.033	\$0.036
Direct Marketing							\$0.118	\$0.122
Manufacturing							\$0.000	\$0.000
Distribution							\$0.078	\$0.078
Overhead							\$0.185	\$0.184
Total Cost							\$0.933	\$0.942
Operating Profit							\$0.256	\$0.267
Licensing income							\$0.144	\$0.122
Operating Profit with Licensing							\$0.400	\$0.389
Songs (millions)							123.9	214.1

In 2006 the wholesale price was \$1.21 and operating profit per song was 27 cents before license revenue allocations and 39 cents after the licensing allocations. Mechanical rates are currently 20% of the wholesale price.

F. Break-Even Analysis – Digital Albums vs. Digital Songs

Since digital albums lose money and digital songs are profitable, it is important to ask, is digital distribution of albums and songs profitable in total?

The combined sale of digital songs and albums has the following revenue and expense profile at the song or track level:

Figure 10: Digital Distribution of Songs & Albums at Song Level (sum of Fig. 4d & 4e)

Digital Albums & Songs	Actual							
	1999	2000	2001	2002	2003	2004	2005	2006
Total Revenue						\$0.654	\$0.657	\$0.636
Mechanical						\$0.085	\$0.085	\$0.091
Artist Royalty						\$0.154	\$0.155	\$0.145
Advances & Recording						\$0.043	\$0.033	\$0.036
Direct Marketing						\$0.110	\$0.118	\$0.122
Manufacturing						\$0.000	\$0.000	\$0.000
Distribution						\$0.065	\$0.078	\$0.078
Overhead						\$0.194	\$0.185	\$0.184
Total Cost						\$0.652	\$0.654	\$0.657
Operating Profit						\$0.002	\$0.003	(\$0.020)
Licensing income						\$0.079	\$0.079	\$0.064
Operating Profit with Licensing						\$0.081	\$0.083	\$0.044
Digital Songs (Millions)						143.6	405.3	706.8

In 2006, based on net sales revenue and without considering license income, profit from digital albums was a negative \$27.7 million and digital singles earned a positive \$13.3 million. (See Figures 3d and 3e, respectively, on page 13). Hence the digital distribution of singles and albums was unprofitable, netting a negative \$14.4 million in 2006. On a per-unit basis, we can see from Figure 9 that in 2006 a digital album lost \$1.34 per album in operating profit while a digital single made \$.03 per song (Figure 4e). Consequently, the music companies would have had to sell approximately 44 digital songs for each digital album sold in order to break even ($\$1.34 / \$0.03 = 44$) based on net sales revenue.

Looked at from the perspective of profitability after an allocation of license revenue, in the aggregate in 2006 the combination of digital singles and digital albums earned a positive \$31.1 million (See Figures 3d and 3e). Since each digital album on average lost \$.65 after allocating license income in 2006, and each digital single earned on average \$.101 (see Figures 4e and 9), in order to break even the record companies needed to sell 6.4 digital singles for each digital album sold ($\$.65 + \$.101$).

Here is what actually happened:

Figure 11: Digital Song Sales Required to Offset Digital Album Losses

Break Even Analysis	2004	2005	2006
Digital Songs Sold:	100.8	273.8	438.4
Digital Albums Sold:	3.3	10.1	20.6
Ratio of Songs sold per Album Sold:	30.6	27.1	21.2
Song Sales Required per Album Sale to Break Even*	28.1	23.8	44.2
Excess (or Shortfall) of Songs Sold per Album:	2.5	3.3	(22.9)
Profits from Digital Song & Albums (\$ mill.)	\$0.2	\$1.4	-\$14.4
*Break Even when Lic. Revenue is Included	na	0.8	6.4

As Figure 11 shows, the ratio of digital singles sold to digital albums sold is decreasing, so that fewer singles were offsetting digital album losses. As mentioned earlier, this is because album sales grew faster in this period than digital song sales: 141.4% CAGR for albums and 110.5% for songs. If this trend continues in the future, as I discuss below, digital margins will become smaller (when looked at after the allocation of license income) or even more unprofitable (when looked at on the basis of net sales revenue).

VI. Future Profitability

Several expert witnesses, notably David Teece and Claire Enders, have developed their own forecasts of the overall growth rates of the recorded music business, as well as having cited various research reports from Veronis Shuler Stevenson ("VSS") and PriceWaterhouseCoopers.¹⁶ No one has attempted to forecast profitability. In the table below I show VSS's projected units for 2007 through 2011. Using the unit profitability from 2006 shown earlier in this report, I have extrapolated profitability for each format and for the total.

¹⁶ RIAA Trial Ex. 64 (Teece WDT), pp 51-58; CO Trial Ex. 10 (Enders WDT), pp 55-59.

Figure 12: Forecasted Profitability Based on Submitted Testimony

Profitability Forecast of Key Music Formats (millions)

VSS Unit Forecasts		2007	2008	2009	2010	2011	CAGR	
CDs		491.9	396.0	321.2	264.0	219.1	-18.3%	
Digital Singles		827.4	1,100.5	1,431.7	1,766.7	2,116.5	26.5%	
Digital Albums		52.0	86.1	131.0	184.1	241.6	46.8%	
Forecast Operating Profit	06 Unit F							
CDs		(\$0.61)	(\$300)	(\$241)	(\$196)	(\$133)	-18.3%	
Digital Singles		\$0.03	\$25	\$33	\$43	\$64	26.5%	
Digital Albums		(\$1.34)	(\$70)	(\$115)	(\$176)	(\$247)	46.8%	
Total		(\$1.92)	(\$344)	(\$323)	(\$328)	(\$354)	3.4%	
Profit after License Income	06 Unit F							
CDs		\$0.32	\$156	\$126	\$102	\$84	-18.3%	
Digital Singles		\$0.10	\$84	\$111	\$145	\$214	26.5%	
Digital Albums		(\$0.65)	(\$34)	(\$55)	(\$85)	(\$119)	46.8%	
Total		(\$0.23)	\$206	\$181	\$162	\$144	-11.3%	
Digital Operating Margin			(\$45)	(\$82)	(\$132)	(\$193)	(\$260)	na
Operating Margin per Track digital track			(\$0.030)	(\$0.037)	(\$0.042)	(\$0.046)	(\$0.049)	na

Beginning with the unit forecast, VSS projected that CD shipments would decline by 18.3% per year, on a compounded basis. Meanwhile, digital singles would grow at 26.5% CAGR and digital albums would grow at 46.8% – faster than singles. In terms of operating profit, applying the profit per unit from 2006, these forecasted changes in unit sales would generate a total loss of \$393 million by 2011. After licensing income allocations, industry profits would decline from \$206 million in 2007 to \$128 million by 2011. This is because digital album losses grow faster than profit from digital singles, even after licensing income.

It is worth noting that the most recent data from Nielsen Soundscan supports these forecasts. In the first quarter of 2008, CD sales dropped 16%, and while digital download sales continued to increase, their rate of growth seems to be slowing.¹⁷

VII. Conclusion

The summary P&L for the Majors in Figure 1 demonstrates that while all other expenses have been going down, the mechanical royalty expense has been increasing. This, coupled with a declining wholesale price, is exacerbating the operating losses of the major labels. While the labels have actively reduced most of the expenses associated with music development and production, the mechanical rate, especially for digital, depends to a great extent on what occurs in this Court.

¹⁷ <<http://www.digitalmusicnews.com/stories/040208quarter/>> (Apr. 3, 2008)

At the unit level, this analysis shows that margins cannot support the rate increases that are being discussed by the publishers. A digital song on average makes \$.04 in profit while the publishers have asked for a rate increase of \$.054 per song, which would drive the operating profit negative. The situation is similar with respect to CD albums, where the margin is \$.02 and the rate increase requested by the publishers is \$.03.

Moreover, demand for digital albums is growing faster than digital singles. Since digital albums lose money and digital singles make money, the industry must sell a significant number of digital singles for each digital album sold just to break even. And it becomes harder and harder to break even as digital album sales escalate. As shown in Figure 12, based on the forecasts previously submitted to the Court, record industry profits will continue to decline despite the rise of digital sales.

In summary, mechanical rates are on the increase as wholesale prices and profits have fallen. This imbalance in risk sharing must be addressed or the record companies will have less and less working capital for artist development, and new releases will decline. The numbers outlined in the testimony support a rate reduction rather than an increase.

Appendix A: McLaughlin Adjusted

Figure 1 of this report shows the P&L for the Major U.S. record companies. This was derived using the testimony of Linda McLaughlin, but we updated her numbers through 2006 and made other adjustments based on new financial data which became available after her original testimony. Ms. McLaughlin's original amended testimony is shown below, followed by our data used in Figure 1 and the difference between them. The rest of this appendix will account for the differences.

US Majors P&L - McLaughlin

In \$US Millions
Historical Aggregated
U.S. Recorded Music
Majors Financial Re-
sults - Exhibit 3A -
Helene Murphy Report

	1999	2000	2001	2002	2003	2004	2005
Net Sales Revenue	\$5,916	\$5,583	\$5,268	\$5,214	\$4,835	\$5,188	\$5,413
Net License Income	526	564	564	520	570	624	661
Total Revenue	6,442	6,147	5,832	5,734	5,405	5,812	6,074
Mechanical Royalties	512	488	440	471	443	487	550
Artist Royalties	1,228	1,148	1,078	1,209	1,061	1,218	1,270
Advances & Recording	412	331	277	350	459	304	247
Direct Marketing	1,094	1,119	1,153	997	832	797	892
Manufacturing	686	610	570	541	576	574	579
Distribution	699	637	621	576	541	508	434
Overhead	1,289	1,329	1,338	1,199	1,409	1,354	1,363
Total Costs	5,919	5,662	5,478	5,343	5,321	5,242	5,334
Operating Profit	\$523	\$485	\$354	\$391	\$84	\$570	\$740

US Majors - Totals from 1999 to 2006

In \$US Millions
From Figure 1

	1999	2000	2001	2002	2003	2004	2005	2006
Net Sales Revenue	5,916	5,583	5,268	5,214	4,835	5,157	5,220	4,847
Net License Income	526	564	564	520	570	624	630	490

Total Revenue	6,442	6,147	5,832	5,734	5,404	5,781	5,850	5,336
Mechanical Royalties	512	488	440	471	443	488	527	547
Artist Royalties	1,228	1,148	1,078	1,209	1,061	1,217	1,229	1,104
Advances & Recording	412	331	277	350	459	304	234	246
Direct Marketing	1,094	1,119	1,153	997	832	766	843	824
Manufacturing	713	630	607	583	594	595	598	511
Distribution	816	745	741	695	628	652	601	563
Overhead	1,289	1,329	1,338	1,199	1,409	1,354	1,318	1,241
Total Costs	6,064	5,791	5,634	5,504	5,426	5,376	5,350	5,036
Operating Profit	378	356	198	231	(22)	405	500	300

Difference: FTI - McLaughlin

In \$US Millions

From Figure 1

	1999	2000	2001	2002	2003	2004	2005	2006
Net Sales Revenue	\$0	\$0	\$0	\$0	\$0	-\$31	-\$193	\$4,847
Net License Income	\$0	\$0	\$0	\$0	\$0	\$0	-\$31	\$490
Total Revenue	\$0	\$0	\$0	\$0	-\$1	-\$31	-\$224	\$5,336
Mechanical Royalties	\$0	\$0	\$0	\$0	\$0	\$1	-\$23	\$547
Artist Royalties	\$0	\$0	\$0	\$0	\$0	-\$1	-\$41	\$1,104
Advances & Recording	\$0	\$0	\$0	\$0	\$0	\$0	-\$13	\$246
Direct Marketing	\$0	\$0	\$0	\$0	\$0	-\$31	-\$49	\$824
Manufacturing	\$27	\$20	\$37	\$42	\$18	\$21	\$19	\$511
Distribution	\$117	\$108	\$120	\$119	\$87	\$144	\$167	\$563
Overhead	\$0	\$0	\$0	\$0	\$0	\$0	-\$45	\$1,241
Total Costs	\$145	\$129	\$156	\$161	\$105	\$134	\$16	\$5,036
Operating Profit	-\$145	-\$129	-\$156	-\$160	-\$106	-\$165	-\$240	\$300

2004 – 2005 Reconciliation of Differences

UMG, Sony BMG and WMG each submitted updated financials for 2004 and 2005. UMG's re-statement substantially restated manufacturing and distribution, while Sony BMG had various changes to net sales and other operating costs, while WMG had minor changes. They are shown in detail below. In particular note that in the "Combined Variances" section, the line item difference match the differences shown on the bottom of the prior page.



Details of Variances from Original LM Statement to Final Label P&L

In \$US Thousands

	2004	2005
<u>Universal Costs Restatement Variance</u>		
Net Sales Revenue		
Net License Income		
Total Revenue Variance		
Mechanical Royalties		
Artist Royalties		
Advances & Recording		
Direct Marketing		
Manufacturing		
Distribution		
Overhead		
Total Costs Variance		
Total UMG Operating Variance		
<u>Sony-BMG</u>		
Net Sales Revenue		
Net License Income		
Total Revenue Variance		
Mechanical Royalties		
Artist Royalties		
Advances & Recording		
Direct Marketing		
Manufacturing		
Distribution		
Overhead		
Total Costs Variance		
Total Sony-BMG Operating Variance		
	2004	2005

Warner

Restated Prior Variance Restated Prior Variance

Net Product Sales (netting Sales Allowance)
Direct Marketing (netting Sales Allowance)
Mechanical Royalties - COS On Reserve Change
Artist Royalties - COS On Reserve Change



Total Warner Operating Variance

Combined Variances

2004

2005

Net Sales Revenue
Net License Income
Revenue Variance

Mechanical Royalties
Artist Royalties
Advances & Recording
Direct Marketing
Manufacturing
Distribution
Overhead
Cost Variance

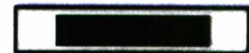
Total Operating Variance



1999 – 2003 Adjustments to Manufacturing & Distribution

Because the UMG restatement of manufacturing and distribution costs in 2004 and 2005 were so significant, they effectively changed the expense profile for those items and brought them more in line with the other majors. UMG's original manufacturing and distribution costs were very low relative to their peers. Consequently we prorated their restatement 2004 and 2005 back to 1999, assuming that they should also have been restated in these years. We did this in consultation with McLaughlin. We first computed the CAGR for these items for 2004 and 2005 and used it in reverse to restate the prior years.

CAGR CALCULATION FOR MANUFACTURING COST



CAGR CALCULATION FOR DISTRIBUTION COST



Having computed the CAGR for manufacturing and distribution, we applied them to the prior years as follows:



Revised Manufacturing Share of Product Sales and Digital Revenue				
1999	2000	2001	2002	
9.2%	9.4%	9.5%	9.6%	



Revised Distribution Share of Product Sales, Digital Revenue and Other Income				
1999	2000	2001	2002	
13.5%	13.8%	14.2%	14.5%	

These percentages resulted in the following dollar adjustments to manufacturing & distribution in 1999 through 2003:

ADJUSTMENTS TO UMG MANUFACTURING & DISTRIBUTION



UNIVERSAL MUSIC GROUP

(in USD \$ 000)

	1999	2000	2001	2002	2003
Net Product Sales	1867300	1853614	1783212	1809049	
Digital Sales	0	0	0	0	
Other Income (MFG, DIST, Ancillary)	0	8,063	11,514	10,520	
Prior Manufacturing	145,800	154,463	133,990	133,470	
Percentage of Product sales & Other Income	7.8%	8.3%	7.5%	7.3%	
Restated Manufacturing (Manufacturing/Product sales & other Income) %	9.2%	9.4%	9.5%	9.6%	
Restated Manufacturing USD\$	171,792	174,998	170,499	174,679	
Variance- Manufacturing Costs	-25,992	-20,534	-36,509	-41,209	
Prior Distribution USD \$	134,500	148,800	134,396	145,091	
Percentage of Product sales, digital sales, & Other Income	7.2%	8.0%	7.5%	8.0%	
Restated Distribution (Distribution/product sales, digital sales & other income) %	13.5%	13.8%	14.2%	14.5%	
Restated Distribution USD\$	252,086	256,911	254,851	263,838	
Variance- Distribution costs	117,586	108,111	120,455	118,747	

Appendix B: Majors' Share of Revenue & Units Shipped by Format

US Majors - Prorata Share of Total US Revenue and Units

In \$US Millions

Historical Aggregated U.S. Recorded Music Majors Financial Results - McLaughlin Testimony

	1999	2000	2001	2002	2003	2004	2005	2006
Total Revenue from Majors	6,442	6,147	5,832	5,734	5,404	5,781	5,850	5,336
Net Sales Revenue	\$5,916	\$5,583	\$5,268	\$5,214	\$4,835	\$5,157	\$5,220	\$4,847
- RIAA Revenue	\$8,600	\$8,477	\$8,107	\$7,351	\$6,895	\$7,132	\$7,010	\$6,499
- Ratio of RIAA to Majors Net Sales	69%	66%	65%	71%	70%	72%	74%	75%

PHYSICAL ALBUMS	1999	2000	2001	2002	2003	2004	2005	2006
CDs (Net Wholesale Revenue)	\$5,303.5	\$5,205.6	\$4,989.8	\$5,005.5	\$4,604.7	\$4,805.1	\$4,374.9	\$3,839.4
Units	523.5	502.0	476.1	487.4	459.5	495.9	463.4	418.7
Cassette	\$393.0	\$225.8	\$121.1	\$68.6	\$34.0	\$6.3	\$4.3	\$0.6
Units	85.0	50.0	29.2	22.1	12.1	3.8	1.8	0.5
LP	\$10.8	\$9.7	\$9.1	\$7.2	\$7.1	\$6.7	\$5.3	\$4.1
Units	2.0	1.4	1.5	1.2	1.1	1.0	0.8	0.5
Music Video	\$124.5	\$98.4	\$114.6	\$113.1	\$153.0	\$222.2	\$219.7	\$162.4
Units	13.6	12.0	11.5	10.4	13.9	23.7	25.2	17.2
Other Albums	\$0.0	\$0.0	\$0.2	\$3.3	\$14.4	\$9.6	\$132.6	\$15.7
Units	0	0	0.0	0.3	1.4	0.8	11.0	1.3

PHYSICAL SINGLES	1999	2000	2001	2002	2003	2004	2005	2006
CD SINGLE	\$63.6	\$35.0	\$24.4	\$7.7	\$13.6	\$6.0	\$4.4	\$2.6
Units	38.5	22.5	11.2	3.2	5.8	2.3	2.1	1.1
CASSETTE SINGLE	\$10.1	-\$0.8	-\$1.7	-\$0.4	\$0.0	\$0.0	\$0.0	\$0.0
Units	9.8	0.9	-1.0	-0.4	0.00	0.00	0	0
LP SINGLE	\$10.0	\$9.0	\$10.5	\$9.0	\$7.8	\$7.5	\$5.2	\$3.5
Units	3.6	3.2	3.6	3.1	2.7	2.5	1.7	1.1
TOTAL PHYSICAL SONGS (MMs)	8218.0	7404.1	6766.7	6789.7	6361.5	6836.9	6537.2	5701.1

DIGITAL MUSIC	1999	2000	2001	2002	2003	2004	2005	2006
TOTAL ALBUMS						\$24.4	\$73.0	\$142.1
Units						3.3	10.1	20.6
ALBUMS						\$24.4	\$73.0	\$141.7
Units						3.291	10.116	20.597
KIOSK ALBUMS						\$0.0	\$0.0	\$0.3
Units						0	0.001	0.052
TOTAL SINGLES						\$69.4	\$193.3	\$307.8
Units						100.8	273.8	438.4
AUDIO SINGLES						\$69.4	\$192.7	\$307.0
Units						100.774	273.263	437.350
KIOSK SINGLE TRACKS						\$0.0	\$0.7	\$0.8
Units						0	0.536	1.012

MUSIC VIDEOS							\$0.0	\$2.0	\$10.5
							0	0.984	5.255
TOTAL DOWNLOADED SONGS							143.6	406.3	712.1
DIGITAL MOBILE MUSIC									
Audio Full Length								\$0.2	\$15.9
								0.2	12.8
Audio Streams								\$0.0	\$0.7
								0.000	0.2
Music Videos								\$0.5	\$2.5
								0.2	5.0
Ring Tunes								\$143.7	\$240.9
								120.2	196.0
Ringback Tunes								\$3.7	\$17.8
								3.7	18.1
Other Mobile (Wall Paper)								\$1.8	\$3.4
								2.3	3.1
Song Equivalents								126.6	235.1
SUBSCRIPTIONS									
(subscribers per month)								\$55.6	\$76.9
								1.300	1.700
Net License Income	\$526	\$564	\$564	\$520	\$570	\$624	\$630	\$490	
Total Revenue	\$6,442	\$6,147	\$5,832	\$5,734	\$5,404	\$5,781	\$5,850	\$5,336	

Appendix C: Development of 2006 P&L for Majors

The purpose of this appendix is to show how the revenue and expenses shown in Figure 1: U.S. Majors P&L was compiled. Each of the next four pages shows the source material and formatted results for each of the Majors, UMG, WMG, Sony BMG and EMI.

The table below shows a reconciliation to Figure 1 for 2006. The first numerical column shows Figure 1 2006 totals. The next four columns show the data from the four labels, as shown in detail on the next four pages. The summation column shows the totals from the labels and the difference columns shows any discrepancies. Of course it should be zero, and is.

Reconciliation to Figure 1				
	Figure 1 2006		Sum	Difference
Net Sales Revenue	\$4,846.8		\$4,846,767.7	\$0.0
Net License Income	489.6		489,572.4	0.0
Total Revenue	5,336.3		5,336,340.0	0.0
Mechanical Royalties	547.1		547,050.3	0.0
Artist Royalties	1,104.2		1,104,176.9	0.0
Advances & Recording	246.0		245,990.0	0.0
Direct Marketing	823.9		823,890.1	0.0
Manufacturing	511.0		511,038.2	0.0
Distribution	543.0		563,014.6	0.0
Overhead	1,248.7		1,240,711.0	0.0
Total Costs	5,035.9		5,035,871.1	0.0
Operating Profit	\$300.5		\$300,468.9	\$0.0

**Universal Source Document
(Source: Linda Mc Laughlin)**



2006 - US\$(millions)	UMG NA Labels
Net Product Sales - WO, JV	
Net Product Sales - P&D (1)	
Net Product Sales	
Local License Sales	
Intercompany Net Sales (including foreign)	
Digital Sales	
Other Income (MFG, Dist, Ancillary)	
Net Sales	
Manufacturing Costs (3)	
Distribution and Other Selling Expenses (3)	
Royalties from Product Sales	
Royalties from Licensing Sales	
Copyright	
Provisions for Returns - COGS offset	
A&R Costs	
Cost of Sales	
Marketing Costs	
Overhead (4)	
Sundry Results (5)	
EBITDA	

Universal Final



UMG NA Labels	In \$US 000s 2006
Net Sales Revenue	
Net License Income	
Total Revenue	
Mechanical Royalties	
Artist Royalties	
Advances & Recording	
Direct Marketing	
Manufacturing	
Distribution	
Overhead	
Total Costs	
Operating Profit	
Operating Profit on Sales	
Reconciliation	
Other Income	
EBITDA	

WMG Source Document

Warner Music Group - US Labels In \$US Thousands	(FY - through Sept 2006) 2006
RIAA Source Document	RIAA 0021083
Net Sales ⁽¹⁾	
Returns Provision	
Digital Sales	
Net Sales Revenue	
Net Domestic Licensing	
Net International Licensing	
Net License Income	
Total Revenues	
Royalties: Artist	
AFM/AFTRA	
Artist Royalty	
JV Participation	
Artist Royalties	
Mechanical Royalties	
Advances & Recording	
Direct Marketing ⁽²⁾	
Manufacturing Subtotal	
Mfg. Portion of Reserve for Returns	
Manufacturing	
COS on Reserve Change	
Artist Portion	
Copyright Portion	
Manufacturing Portion	
Distribution Overhead Costs	
Distribution Costs	
Return Provision Recovery Dist.	
Bad Debt Expense	
Distribution	
Selling Department	
A&R Department	
Marketing Department	
G&A	
Overhead	
Total Costs	
Pre-Tax Income	
Reconciliation	
Distribution Fees	
Publishing & Print Revenues	
Total Other Revenues	
Pre-Tax Income RIAA 21083	
Note:	

WMG Final

WMG Labels NA	In \$US 000s 2006
Net Sales Revenue	
Net License Income	
Total Revenue	
Mechanical Royalties	
Artist Royalties	
Advances & Recording	
Direct Marketing	
Manufacturing	
Distribution	
Overhead	
Total Costs	
Operating Profit	
OIBDA	
Operating Profit on Sales	
Reconciliation	
Distribution Fees	
Publishing & Print Revenues	
Total Other Revenues	
Pre-Tax Income RIAA 21083	

EMI Source Document

EMI Final

EMI Labels - North America	06/07
In \$US Thousands	2006
RIAA DOC	45561-45562
Net Revenue	
3rd Party Sales	
Net Sales Revenue	
Net License Income	
Artist Royalties ^{<1}	
Mechanical Royalties ^{<2}	
Manufacturing	
Distribution	
Advances & Recording	
Direct Marketing ^{<3}	
Overhead	
Total Costs	
Digital Net Sales ^{<4}	
Distribution Overhead Reallocation	
Profits before Exceptionals	
¹ Called Royalties Costs on Net Domestic Sales.	
² Called Copyright Cost.	
³ Called Total Marketing & Promotion.	
⁴ Already included in Net Revenue.	

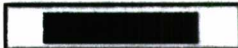
EMI Labels	In 000s
NA	2006
Net Sales Revenue	
Net License Income	
Total Revenue	
Mechanical Royalties	
Artist Royalties	
Advances & Recording	
Direct Marketing	
Manufacturing	
Distribution	
Overhead	
Total Costs	
Operating Profit	
Operating Profit on Sales	

SBMG Source Document



SONY BMG Music Entertainment	
In \$US	
Gross Product Sales	
Returns	
Allowances & Discounts	
Net Sales	
Net Royalty Income	
Other Operating Revenue	
Total Revenue	
Artist, AFM Royalties	
Copyright Royalties	
JV Royalties	
Talent & Recording Costs	
Manufacturing Costs	
Obsolescence Expense	
Distribution Costs	
Other	
Total Cost of Sales	
Gross Profit	
Variable Marketing Costs	
Cooperative Advertising	
Total Marketing	
Departmental Overhead	
Overhead Assessments	
Total Overhead	
Operating Income	
Footnotes:	

SBMG Final



Sony-BMG	In 000s
NA	2006
Net Sales Revenue	
Net License Income	
Total Revenue	
Mechanical Royalties	
Artist Royalties	
Advances & Recording	
Direct Marketing	
Manufacturing	
Distribution	
Overhead	
Total Costs	
Operating Profit	
Operating Profit on Sales	
<u>Reconciliation</u>	
Other Operating Revenue	
Other Expense	
Operating Income	

I declare under penalty of perjury that the foregoing testimony is true and correct.



Bruce Benson

Date: 05/01/2008