Before the
COPYRIGHT ROYALTY BOARD
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Washington, D.C.

In the Matter of	)	
	)	Docket No. 2009-1, CRB Webcasting III
DIGITAL PERFORMANCE RIGHT IN SOUND RECORDINGS AND EPHEMERAL RECORDINGS	)	

REBUTTAL STATEMENTS OF LIVE365, INC.

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Dated: June 7, 2010

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RECORDINGS AND EPHEMERAL	)	
RECORDINGS	)	
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INTRODUCTORY MEMORANDUM TO THE WRITTEN REBUTTAL CASE OF LIVE365, INC.

Live365, Inc. ("Live365"), through its undersigned counsel, respectfully submits this Introductory Memorandum to its written rebuttal case in accordance with 37 C.F.R. § 351.11. This Memorandum summarizes the contents of Live365's rebuttal case and briefly summarizes the testimony of its rebuttal witnesses.

Live365's rebuttal submission consists of the following documents:

1. This Introductory Memorandum;
2. Dr. Michael Salinger's Written Rebuttal Testimony;
3. Alexander "Sandy" Smallens' Written Rebuttal Testimony;
4. Motion for Application of the Protective Order, including a Declaration and Rule 11 Certification;
5. Redaction Log; and
6. Live365's Clarification Regarding Terminology & The Operations of Live365.

Pursuant to 37 C.F.R. § 350.4(a) and the Copyright Royalty Board's Order of June 24, 2009, Live365 is filing an original, five copies, and one electronic copy of the documents identified

above, in addition to public versions of the documents containing materials that have been designated as Restricted under the Protective Order.

Live365's written rebuttal case comprises the written statements of the following individuals:

Dr. Michael Salinger is a professor of economics at the Boston University School of Management and a Managing Director of LECG, a company that provides economic analysis for legal and regulatory proceedings. Dr. Salinger is an expert in economics and statistics, specializing in industrial economics. Dr. Salinger's rebuttal testimony responds to the written and oral testimony provided by Dr. Michael Pelcovits during the direct phase of this proceeding. With respect to the "Interactive Services" benchmark discussion, Dr. Salinger explains how Dr. Pelcovits' analysis is incurably flawed and unreliable. Dr. Salinger concludes, among other things, that: (1) Dr. Pelcovits' benchmark rate of $0.0036 makes no economic sense, (2) his analysis is riddled with selections biases and other methodological errors that inflate his recommended rate; and (3) Dr. Pelcovits' hedonic regression analysis is irrelevant.

Dr. Salinger also rebuts Dr. Pelcovits' reliance on the royalty rates contained in the Webcaster Settlement Act ("WSA") agreements that SoundExchange reached with the National Association of Broadcasters ("NAB") and with Sirius XM Radio ("Sirius XM"). Dr. Salinger concludes that these WSA agreements contain rates that are inflated compared to what would have been negotiated in the marketplace between a willing buyer and a willing seller. The reasons for this inflation are manifold, including: (1) SoundExchange's ability to determine which WSA agreements would be precedential allowed it to select the highest rates for consideration in this proceeding and to exclude the most relevant and representative marketplace rates; (2) SoundExchange, as a collective seller operating on behalf of competing record

companies, could effectively extract rates higher than what the individual sellers could obtain individually; and (3) both the NAB and Sirius XM – who were incentived to raise the costs of their rivals (something that Dr. Pelcovits fails to consider) – appear to have been induced to accept higher rates for 2011-2015 in exchange for rates below those to which SoundExchange was legally entitled for 2009-2010. All of the foregoing leads Dr. Salinger to conclude that the wide range of rates presented by Dr. Pelcovits do not represent the marketplace rates for the 2011-2015 period.

Alexander "Sandy" Smallens is the founder and managing director of a digital media consultancy, Audiation, Inc., and has substantial expertise in the webcasting industry. Mr. Smallens rebuts the rosy assessment of the statutory webcasting industry that was presented in SoundExchange's direct case. Mr. Smallens explains that – contrary to statements made in SoundExchange's direct case, and specifically by Dr. Pelcovits – statutory webcasting services are facing substantial economic challenges that point to a less-than-robust market. Mr. Smallens discusses the formidable challenges that statutory webcasters face in attempting to maximize revenues, especially in the face of substantial royalty obligations. Mr. Smallens also discusses the promotional benefits to copyright holders that non-interactive services provide.

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Separate from the foregoing written rebuttal statements, Live365 is also submitting a document that attempts to clarify certain terms used by Live365's witnesses and how they relate to Live365's business operations. *See* Live365's Clarification Regarding Terminology & The Operations of Live365. This document is being submitted in response to Judge Roberts' request

(made at the end of the direct case hearing)[1] that Live365 provide such clarification in the rebuttal phase due to inconsistent terminology used during the direct case hearing.

Respectfully submitted,

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Dated: June 7, 2010

[1] Direct Hearing Transcript (Docket No. 2009-1, CRB Webcasting III), April 28, 2010, at 1362:18 - 1363:17.

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WRITTEN REBUTTAL TESTIMONY OF

DR. MICHAEL A. SALINGER

June 7, 2010

I. QUALIFICATIONS

1. My name is Michael A. Salinger. I am Professor of Economics at the Boston University School of Management and Managing Director of LECG, a company that provides economic analysis for legal and regulatory proceedings.

2. From July 2005 through June 2007, I took a leave of absence from Boston University to serve as Director of the Bureau of Economics at the United States Federal Trade Commission (FTC).

3. I joined the Boston University faculty in 1990. Most of the courses I have taught have been in managerial economics or statistics. I have taught economics at the undergraduate, masters, doctoral, and executive level. I have taught statistics at the undergraduate and masters level. I have also taught business history, health care economics, and health care finance. I have been faculty director of the undergraduate business program, faculty director of the undergraduate honors program in the School of Management, and chairman of the Department of Finance and Economics. After returning to Boston University from the FTC, I was named an Everett W. Lord Distinguished Faculty Scholar. Prior to joining the Boston University faculty, I was an associate professor at the Graduate School of Business at Columbia University.

4. My area of specialization within economics is "industrial economics" (or "industrial organization"). I have published on a wide variety of economic topics and have served on the editorial boards of both *The Journal of Industrial Economics* and *The Review of Industrial Organization*, two journals that specialize in publishing academic articles on industrial economics. I am currently a co-editor of *Competition Policy*

International, a policy-oriented academic journal that focuses on competition policy and regulation.

5. My prior experience as an expert witness includes two appearances before a Copyright Arbitration Royalty Panel and one before the Copyright Royalty Board, all on behalf of Devotional Broadcasters in proceedings to determine the allocation of copyright royalty fees paid by cable operators for the retransmission of distant broadcast signals. Two of those appearances (and the reports associated with them) concerned my evaluation of econometric studies put forward by other parties as possible bases for allocating the copyright fees. My prior consulting experience also includes a report and deposition testimony for Turner Broadcasting (which at the time was owned by Time-Warner) about the fees cable networks should pay ASCAP for the performance rights to music in the programming on its cable networks.

6. My affiliation with LECG started on August 1, 2007. Prior to working at the FTC, I was a special consultant to NERA and, before that, an academic adviser to the Princeton Economics Group. Over my career, I have worked on a variety of consulting assignments associated with legal and regulatory proceedings.

7. I received my BA, *magna cum laude* and with honors in economics, from Yale University in 1978. I received a Ph.D. in economics from the Massachusetts Institute of Technology in 1982.

8. For further details on my qualifications, see my curriculum vitae, which is attached as Exhibit 1 to my statement.

II. ASSIGNMENT

9. I have been asked by counsel to Live365 to review and comment on the report by Dr. Michael D. Pelcovits submitted by SoundExchange in support of its proposal for rates to be paid by non-interactive webcasting services for the use of sound recordings under the statutory licenses set forth in 17 U.S.C. §§ 112 and 114.

III. SUMMARY OF DR. PELCOVITS' MAIN POINTS

10. SoundExchange asked Dr. Pelcovits to determine a range of royalty rates that would be reasonable for non-interactive services to pay the copyright owners of the sound recordings they transmit. He claims to have tried to determine rates that should "most clearly represent the rates and terms that would have been negotiated in the marketplace between a willing buyer and willing seller."[1]

11. In broadest terms, the methodology Dr. Pelcovits uses to assess the reasonableness of the proposed rates is a "benchmark analysis." Generally speaking, a benchmark analysis of a reasonable rate requires: (1) a "benchmark rate" (i.e., some rate that we can observe which is different than the one which we are trying to determine); and (2) an "adjustment factor" to get the "target rate" (i.e., the rate to be determined).

12. Dr. Pelcovits computes two benchmarks based on existing contracts for copyright royalties. In one, which I will call the "WSA Agreement Approach," the "benchmark rates" are per-play rates agreed to between SoundExchange and two sets of webcasters for rights governed by the compulsory license that forms the basis of this proceeding. One set of webcasters who agreed to the rates used in this analysis is radio

[1] SoundExchange Trial Ex. 2 (Amended & Corrected Written Direct Testimony of Dr. Michael Pelcovits, Feb. 16, 2010 ("Pelcovits ACWDT")) at 2.

stations represented by the National Association of Broadcasters ("NAB"). The other set of rates used in this analysis comes from an agreement with Sirius XM Radio to cover Internet streaming of programming that it produces. In determining this benchmark, Dr. Pelcovits merely averages the rates to which these two groups agreed. With this average, Dr. Pelcovits makes no adjustment. Under the "WSA Agreement Approach," the "benchmark rates" and the "target rates" range from $0.00175 per play in 2011 to $0.00245 in 2015.[2]

13. In the second benchmark approach, which I will refer to as the "Interactive Services Approach," the "benchmark rate" is the average of royalties agreed to between the four major record companies and a handful of interactive music services (which do not qualify for a compulsory license). To reach his royalty for the non-interactive services, Dr. Pelcovits uses an adjustment factor. The basis of this adjustment factor is Dr. Pelcovits' determination that the royalties should comprise approximately the same percentage of the revenues for both the interactive and the non-interactive services.[3] In Pelcovits' calculations, this ratio requires the royalties in both the non-interactive and interactive markets to be approximately 47.4% of the revenue generated by subscription services.[4] Under the "Interactive Services Approach," Dr. Pelcovits computes a target royalty rate for non-interactive services to be $0.0036 per play.[5] This means that, using

[2] SoundExchange Trial Ex. 2 (Pelcovits ACWDT) at 4.

[3] SoundExchange Trial Ex. 2 (Pelcovits ACWDT) at 23 ("I believe it is reasonable to predict that the ratio of per-subscriber royalty fees to consumer subscription prices will be essentially the same in both the benchmark and target markets.")

[4] This number is calculated from examining the ratio in the interactive market as follows: $0.02194 / ($13.30/287.37) = .474 or 47.4%. *See* SoundExchange Trial Ex. 2 (Pelcovits ACWDT) at 25, 30, and 31.

[5] SoundExchange Trial Ex. 2 (Pelcovits ACWDT) at 4.

his assumptions about the ratio of royalties to revenues, Dr. Pelcovits would expect revenue per play to be approximately $0.0073 for non-interactive services.[6]

14. Dr. Pelcovits opines that any rate that SoundExchange proposes within the range spanned by his two benchmark approaches would be reasonable.

IV. SUMMARY OF MAJOR FLAWS OF DR. PELCOVITS' ANALYSIS

15. **Dr. Pelcovits does not examine the impact of his rates on a willing buyer.** A conclusion that a royalty rate of $0.0036 would be reasonable makes no economic sense. This is because a royalty at that rate would not only exceed the percentage of revenue of a service that Dr. Pelcovits posits as appropriate, but it would significantly exceed the ***total*** revenue per play that the Internet radio industry has been able to earn. An Internet radio service would only agree to a royalty per play that is sufficiently below its revenue per play to allow it to cover its other economic costs. Dr. Pelcovits has provided no analysis to suggest that a willing buyer could realistically afford the rate his methodology suggests.

16. **Dr. Pelcovits' benchmark approach is a conceptual shortcut that is inherently prone to error.** It should come as no surprise that Dr. Pelcovits' analysis could lead to a false conclusion. The stated logic behind the $0.0036 estimate is that it would cause royalties to be the same percentage of revenue for non-interactive services as it is for interactive services. Even if Dr. Pelcovits had implemented his approach

[6] Dr. Pelcovits reports that the average non-interactive subscription rate is $4.13, and the average number of plays per subscriber is 563.36. *See* SoundExchange Trial Ex. 2 (Pelcovits ACWDT) at 25, 32. The ratio of $0.0036 to $0.0073 is slightly greater than 47.4% because of an additional detail of the calculation that is inappropriate and that inflates the estimate somewhat. See the discussion of Dr. Pelcovits' regression analysis in Section VII.

sensibly (which he did not), the approach is at best a shortcut. A more thorough approach to determine what willing buyers in the marketplace would pay is to examine their business models. Doing so would require understanding how they generate revenue and what costs they must incur in order to generate that revenue. Dr. Pelcovits did not perform such an analysis (even in his subsection entitled "Evolution of Webcasters' Business Models"). This less-than-rigorous shortcut benchmark approach is at best an approximation that is prone to error even when implemented correctly.

17. Dr. Pelcovits' estimate of revenues per play for non-interactive services is based entirely on subscription fees even though non-interactive services are primarily advertising-supported. Dr. Pelcovits' estimate that willing buyers would pay $0.0036 per play is based on his estimate that non-interactive services generate revenue of $0.0073 per play, which is likely far greater than they in fact are able to generate. The most important source of upward bias in Dr. Pelcovits' estimate of revenues per play of non-interactive services is that he estimates revenue per play with subscription rates even though the vast majority of listening on non-interactive services is non-subscription (i.e., ad-supported). This flaw alone is sufficient reason to dismiss the "Interactive Services Approach" as having no value for predicting what the typical non-interactive service would be willing to pay.

18. **Dr. Pelcovits makes further selection biases which ignore industry realties and inflate his recommended royalty rate.** Among the additional details of Dr. Pelcovits' calculations that reveal inherent selection bias are: (1) in determining rates paid by interactive services, he relied only on contracts with the four major record companies, thus assuming without foundation that independent record labels (which

account for a substantial portion of the music streamed on non-interactive sites) would be able to command the same fees; and (2) in the calculation of Effective Per Play Rate paid by interactive services, Dr. Pelcovits ignores the downward trend in these rates causing the average rate that he relies on to be biased upward.

19. **Use of hedonic price regression is inappropriate.** Dr. Pelcovits uses hedonic regression analysis to estimate what portion of the difference in average subscription rates between interactive and non-interactive services is attributable to interactivity (as opposed to other ways in which non-interactive and interactive services are different from each other). Even if it were appropriate to use subscription rates to measure revenue per subscriber, there would be no reason to distinguish between the effect of interactivity and other features on subscription rates.

20. **Reliance on the precedential WSA deals leads to an unjustified upward bias.** The lower bound of the range determined by Dr. Pelcovits through his WSA Agreement Approach is also tainted by upward bias. The foundation for this set of rates comes from the average of rates under two WSA agreements. The rates in these agreements have at least three upward biases regarding rates to which willing buyers and willing sellers would agree. First, the seller in these agreements, SoundExchange, is a monopoly seller that can naturally extract higher rates than those that would be expected if individual sellers competed against each other. Second, SoundExchange gets to select which of its agreements it allows into evidence in this proceeding. The ones it allows into evidence are an upwardly biased sample of all the agreements they might reach. Third, the rates SoundExchange cites for 2011-2015 were parts of agreements in which SoundExchange accepted lower rates for 2009-2010 than it was legally entitled to. This

suggests that SoundExchange used the discount for the earlier period to induce the buyers to accept higher rates than they would have in an agreement that just covered 2011-2015. Because of these upward biases, the CRB should disregard Dr. Pelcovits' WSA Agreement Approach.

21. **The NAB and Sirius XM had an incentive to enter into the precedential WSA Agreements to raise their rivals' costs.** Dr. Pelcovits ignored another reason for questioning whether the rates reflected by these agreements are an appropriate benchmark. Under the economic theory of "Raising Rivals' Costs," a firm can benefit from an increase in the market price of an input that is a more important cost component for its competitors than it is to the firm. Even though the firm's costs go up, its competitors' costs go up even more. Since Internet radio companies are strategic threats to both the terrestrial broadcasters represented by NAB and to Sirius XM, and since the rates determined in this proceeding will have a bigger effect on the costs of Internet radio companies than on terrestrial or satellite radio companies (who derive the vast majority of their revenue from their traditional businesses, not from Internet radio), the NAB and Sirius XM likely would have found it beneficial to accept higher rates for 2011-2015 in order to impose these higher costs on its rivals.

22. For these reasons, as set out in more detail below, the Copyright Royalty Judges should not rely on either of Dr. Pelcovits' benchmark analyses in setting the rates in this proceeding.

V. DR. PELCOVITS' INTERACTIVE BENCHMARK RATE MAKES NO ECONOMIC SENSE TO A WILLING BUYER

23. Using his "Interactive Services Approach," Dr. Pelcovits concludes that Internet radio services would willingly accept a rate of $0.0036 per play. In conducting any benchmark analysis, as it is a substitute to be used only when the data for a more rigorous approach are not available, one must use care to ensure that the rate derived through the benchmark approach makes economic sense. Dr. Pelcovits simply did not observe this fundamental requirement.

24. It makes no economic sense to suggest that willing buyers would pay $0.0036 per play because there is no compelling evidence that Internet radio services can earn ***total revenues*** per play of $0.0036, much less a rate that would allow them to pay such a royalty ***and*** cover all of their other costs of operation. A willing buyer would not buy at a rate that would not allow it to cover its costs and earn a reasonable rate of return.[7]

25. The service which, according to Dr. Pelcovits, is the fastest growing and largest webcasting service would not be a willing buyer at the proposed $0.0036 rate. Based on public reports of Pandora's revenues (which were available to Dr. Pelcovits before the filing of his report) and SoundExchange performance data from this proceeding on Pandora's plays, I estimate that Pandora's total revenues per play were $[redacted] in 2008 and $[redacted] in 2009.[8] Given that Pandora's yearly total revenue per

[7] In fact, Dr. Pelcovits concedes that a willing buyer, "over time, [ ] would need to cover cost[s] and operate a profitable business. . . ." Direct Hearing Tr. (April 19, 2010) at 214:21-215:3.

[8] Pandora's 2008 revenues per play of $[redacted] is based on Pandora revenues of $19 million (*see* "Music Labels Reach Online Royalty Deal," The New York Times, 7/8/2009), divided by [redacted] million plays (*see* SXW3_Native_0015). Pandora's 2009 revenues per play of $[redacted] is based on Pandora revenues of $50 million (*see* "How Pandora Slipped Past the

play is well below the royalty rate derived by Dr. Pelcovits, it defies logic that Pandora would be a willing buyer at the $0.0036 rate proposed by Dr. Pelcovits. If the largest and best known webcaster earns revenue at a rate approximately half that of the proposed royalty, one must conclude that there is a significant flaw with the proposed royalty and the method used to derive it.

26. Ultimately, whether a non-interactive service would agree to a royalty of $0.0036 turns on the revenues per play it can generate (as well as the other costs it incurs in generating those revenues). Given the mix of subscribing and non-subscribing listeners, the revenue per play that a non-interactive service can generate reflects a weighted average of what revenues it obtains from subscribers and from non-subscribers, with weights determined by the actual mix of plays to subscribers and non-subscribers. Based on Accustream data, I have estimated that total webcasting ad revenues per play were $0.0023 in 2008.[9] Solely for purposes of these calculations, I have accepted Dr. Pelcovits' estimate of a non-interactive service being able to earn $0.0073 per play for its subscription service.[10] The remaining input required for the calculation of a non-interactive services revenue per play is the fraction of plays that relate to subscribers and non-subscribers. One possible foundation for this fraction comes from SoundExchange's

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Junkyard", The New York Times, 3/7/2010), divided by [redacted] million plays (see SXW3_Native_0026). The [redacted] million plays is an estimate based on apparently 10 months of data. Specifically, I estimate the figure by determining the average monthly plays for the first 10 months then extrapolating for the final two months. The formula is ([redacted]/(10/12)). I also compared the [redacted] million performances in SXW3_Native_0026 to performance data reported for Pandora in SXW3_Native_0015 which totaled [redacted] million performances for what appears to be approximately a 10 month period.

[9] In 2008, Accustream reports ad revenue of $84 million and 36,883 million performances. *See* Live365 Trial Ex. 30, Exhibit 3.

[10] Dr. Pelcovits reports that the average non-interactive subscription rate is $4.13, and the average number of plays per subscriber is 563.36. *See* SoundExchange Trial Ex. 2 (Pelcovits ACWDT) at 25, 32.

budget reports. For webcasters who have entered into the Pureplay deal, the budget reports both non-subscription and subscription plays. For 2009, the annualized budget for non-subscription plays is [redacted] million and the comparable subscription number is [redacted] million. Thus, based on the most recent data, [redacted]% of plays are to non-subscribers and only [redacted]% are to subscribers.[11] Combined with the above estimates of the revenue per play achievable from each type of listener implies that the overall achievable revenue per play is $[redacted] which is substantially below Dr. Pelcovits' estimated royalty rate of $0.0036. Thus, where the ***total*** revenue per play for a non-interactive webcaster is $[redacted] ***less*** than the per play royalty that Dr. Pelcovits assumes is appropriate for the sound recording royalty alone, his calculations must be flawed.

27. The evidence presented above concerns the market as it currently exists. This proceeding is to set rates for 2011-2015. While the market might develop to allow non-interactive services to generate additional revenues per play, Dr. Pelcovits has presented no evidence of this. Dr. Pelcovits' section on evolving business models discusses market developments that purportedly enhance the value of the service provided by Internet radio, and suggests that these developments may increase the revenue per subscriber that they will be able to earn. That discussion is entirely qualitative, however. Dr. Pelcovits has no foundation for how much revenue ***per play*** non-interactive services might generate in the future. Moreover, and more importantly, these future developments have nothing to do with Dr. Pelcovits' calculations that went into deriving his estimate that willing buyers would agree to royalties of $0.0036 per play. Dr. Pelcovits bases that estimate entirely on historic data for rates charged in the

[11] SoundExchange Budget, SXW3_00016582 (attached as Exhibit 2); *see also* Direct Hearing Tr., (April 21, 2010), at 506:16-508:2.

interactive marketplace and for the number of historical plays in both the interactive and non-interactive markets. It reflects the market as it is, not as it may be at some point in the future. He cannot justify his unreasonable conclusion about the market as it currently exists on the grounds that future developments might somehow make it true.

VI. DR. PELCOVITS' ANALYSIS CONTAINS NUMEROUS METHODOLOGICAL FLAWS AND SUFFERS FROM SELECTION BIAS

28. Given the evidence that casts doubt on Dr. Pelcovits' ultimate conclusions, it is worth considering how his methodology for arriving at those conclusions went astray. There are many sources of error.

A. Benchmark Analysis Is A Shortcut

29. Dr. Pelcovits did not directly address the question of what a willing buyer would pay. To do so, he would have had to analyze the business models of Internet radio services. This would have entailed assessing their sources of revenue, their costs (including a return to cover the opportunity cost of invested funds),[12] and how a proposed royalty would affect their decisions (such as pricing). Dr. Pelcovits has not done this. Instead, he has used a "benchmark" approach. This entails taking an observed

[12] Any textbook on managerial economics recognizes the opportunity cost of invested funds as a legitimate cost. Put another way, companies are in business to make a profit; and those that cannot make a rate of profit available in other activities will not stay in business. Dr. Pelcovits appears to agree with this principle. *See* Live365 Trial Ex. 5 (Testimony of Michael Pelcovits dated October 2005), at 34-5 (". . . [T]he demand by music services for copyrighted music is essentially the same as the consumer's demand for music services using that work, less the music services' costs of production (other than the copyright fee itself) and a reasonable profit."); *see also* Exhibit 3 to this report RIAA Exhibit No. 108 DP, "Estimation of Economic Value of Webcaster Statutory Licenses," submitted in 2000-9 CARP DTRA 1 & 2, at 15 ("If a webcaster had to pay statutory license fees equivalent to the total economic value, the business would just break even and the there would be no profit remaining for the owner of the business. Therefore, the fee for the statutory licenses should be based on some portion of the value of the statutory licenses, which allows investors/owners to make a reasonable return on their investment.")

"benchmark rate" and then applying an "adjustment mechanism" to arrive at a "target rate." The principle underlying Dr. Pelcovits' "adjustment factor" is that the ratio of royalties to revenues should be equal for interactive and non-interactive services. At best, however, this is an approximation to be used because it is convenient, not because it is correct. As with any convenient approximation, it is prone to errors.

30. Even if Dr. Pelcovits was justified in starting with agreements with interactive services and in assuming that the ratio of royalties to revenues should be the same for interactive and non-interactive services, his implementation was systematically biased to inflate the "target rate."

B. Implicit And Incorrect Assumption That All Users Are Paying Subscribers

31. Dr. Pelcovits' entire analysis relies upon data from subscription services only. This applies to his effective per play rate, adjustment factor for differences in plays, and his interactivity adjustment. However, even as Dr. Pelcovits has acknowledged, the vast majority of listening hours, listeners, and webcasting services are ***not*** subscription based.[13] For example, as previously discussed, subscription listening accounts for [redacted]% of the reported performances by webcasters that have entered into the Pureplay agreement.

32. Further, subscription revenue per play is significantly greater than what a service can generate from advertising. Subscription revenue per play earns roughly three times more than advertising revenue per play.[14] Dr. Pelcovits' use of subscription rates to

[13] Dr. Pelcovits admitted at trial that both the majority of listening hours and listenership comes from advertising services. Direct Hearing Tr. (April 20, 2010) at 312:7-313:5.

[14] Based on 2008 Accustream data, webcasting ad revenues per play were $0.0023. Dr. Pelcovits calculates subscription revenue per play to be $0.0073.

measure revenue per play is akin to estimating revenue per seat for an airline by assuming that all passengers pay full, first class fares. Unless it is feasible to run an airline with only first class service and no discounts on seats, such a calculation would grossly overstate the revenue an airline could practically earn. Dr. Pelcovits has not shown that a purely subscription-based non-interactive service can be operated profitably (or that one even exists).

33. Given that data on total revenues and total plays (in other words, both subscription and advertising-based plays) was available to Dr. Pelcovits, he could have estimated the appropriate royalty rate using a more realistic assessment of the industry. For illustrative purposes, Exhibit 4 describes the total revenue per play for both Pandora and Live365. Exhibit 5 then shows how using Dr. Pelcovits' ratio and total plays for these services would result in a royalty rate of $[redacted] per play with 2008 data and $[redacted] per play with 2009 data. These rates are far below the $0.0036 per play that Dr. Pelcovits calculates, far below the rates proposed by SoundExchange, and even below the rates suggested by Live365. As Pandora's and Live365's combined share of the industry is large enough,[15] I am confident that Dr. Pelcovits' indirect estimate of revenue per play based on subscription rates substantially overstates the revenue per play for the industry as a whole.

34. Of the many problems with Dr. Pelcovits' analysis, the use of the subscription rates as the foundation for estimating revenue per play is the biggest source of error and the most important reason why the "Internet Services Approach" leads to a conclusion that makes no economic sense. In my opinion, the Copyright Royalty Judges

[15] *See* "Top 25 Webcasters by Usage: 2009" (SXW3_Native_0015) (RESTRICTED).

should disregard this approach and Dr. Pelcovits' conclusion that $0.0036 per play represents a rate that one might expect to observe between willing buyers and sellers.

C. Failure To Analyze Independent Label Contracts And Performances

35. Dr. Pelcovits computes his benchmark rate of $0.02194 by dividing total royalty payments by total plays for six interactive music services with the four major record companies in the 2007 to 2009 time period.[16] He did not include, or review, a single contract with independent record companies (despite reviewing 214 agreements and amendments with the major labels).[17] Content from independent labels represents a substantial percentage of music streamed on non-interactive services. For example A2IM (American Association of Independent Music), a SoundExchange Board member, has reported that approximately 40% of all music streamed on non-interactive services like Yahoo! and SomaFM comes from independent labels.[18] Moreover, over 50% of the music streamed on Pandora comes from non-major labels.[19] The omission of such a large

[16] SoundExchange Trial Ex. 2 (Pelcovits ACWDT) at 30; SXW3_Native_0016 (RESTRICTED).

[17] Post Hearing Responses to Judges' Questions by Michael D. Pelcovits, May 18, 2010, at 2.

[18] "What is Net Neutrality," March 5, 2009 Newsletter at http://a2im.org/tag/net-neutrality/ ("The value of this access to Independent labels is demonstrated by the almost 40% of market share Independent labels have at digital streaming sites like Pandora, Yahoo!, SomaFM, etc., as reported by SoundExchange. . . ."); *see also* "Indie Music Memo To FCC: We Need A Level Playing Field Too," Rich Bengloff (President of A2IM), January 15, 2009 at http://www.huffingtonpost.com/rich-bengloff/indie-music-memo-to-fcc-w_b_158173.html (". . . according to the non-profit performance royalty collection society SoundExchange . . . almost 40% of audience impressions for non-terrestrial broadcasts are from independent music. . . .")

[19] "Indie labels are on the rise, and the proof is in the numbers," The Music Industry Report, May 21, 2009 at http://musicindustryreport.org/?p=8473 ("On top internet broadcasting platforms, where consumer choice reigns, indies thrive. Overall, independent music makes up approximately 40% of all music played at non-traditional web radio and at industry leading webcaster Pandora, over half of the music users play is independent."); *see also* Interview with Pandora founder Tim Westergren, http://www.volume11.us/2010/02/17/are-you-on-pandora/ ("Q: What percentage of music played on Pandora is by independent artists? A: It's around 50% on a spin-weighted basis").

percentage of the performances (and the corresponding royalty deals under which these performances are covered) highlights another serious flaw in his analysis. If royalty rates charged by independent labels are less than the rates charged by the four major labels that Dr. Pelcovits includes in his sample, Dr. Pelcovits' estimated non-interactive rate is biased upward.

36. Dr. Pelcovits does not explain why he excluded an entire category of copyright owners that he acknowledges represents a significant share of sound recording performances. Many independent labels are SoundExchange members, and in fact the SoundExchange Board has independent label representatives. Although SoundExchange has not provide any contracts or witness representatives of independent labels, these entities may have less bargaining power than the major labels and may be more interested in promotion to increase their market share. If so, the sound recording royalty rate charged by independent labels could quite plausibly be lower than the rates for the major labels. In fact, evidence provided by Live365 during the Direct Phase showed that some independent labels are willing to waive the royalty. *See* Live365 Trial Ex. 29 (Floater Corrected Written Direct Testimony), at 13.

37. In sum, Dr. Pelcovits has only examined the type of service that would generate the highest return for the content owner (a subscription service that plays only content from the major record labels). A more representative sample might have produced a significantly lower estimate of a reasonable rate.

D. Downward Trend In The Effective Per Play Rate

38. Dr. Pelcovits derives an effective per play rate by examining royalty payments from six interactive services to the major labels and dividing by reported

performances.[20] His analysis averaged these payments over an 18 month time period between 2007-2009. *See* Trial Tr. (April 20, 2010) 309:16-310:21.

39. The effective per play rate for the interactive services calculated by Dr. Pelcovits declines from $0.02610 in 2007 to $0.01917 in 2009.[21] Dr. Pelcovits fails to take into consideration this downward trend in the data and instead relies on the average royalty per play of $0.02194 over the time period. As a result, the benchmark rate overstates the *current* value that willing buyers and sellers place on a license in the interactive market, which causes the estimated non-interactive rate to be higher than it would be based on the actual rates currently paid in the interactive market.

VII. THE IRRELEVANCE OF, AND PROBLEMS WITH, DR. PELCOVITS' REGRESSION ANALYSIS

A. Dr. Pelcovits' Regression Is Irrelevant

40. As noted above, there are two components in Dr. Pelcovits' benchmark analysis: (1) a benchmark rate, and (2) an adjustment factor. Dr. Pelcovits performs these calculations three different ways and then averages them. The third calculation relies on a hedonic regression analysis.[22]

[20] With respect to the effective per play rate calculation of $0.02194, Dr. Pelcovits relies upon data from just six interactive services (Altnet, Classical Archives, Imesh, Microsoft/ZunePass, Napster and Rhapsody). Further, with respect to Dr. Pelcovits' per play adjustment, Dr. Pelcovits relies on just five interactive services and one custom service used as a proxy for "non-interactive." The concern generally created by this selective use of data is that the observations were cherry-picked to obtain a desired solution. Dr. Pelcovits has done nothing to dismiss this concern. *See* SoundExchange Trial Ex. 2 (Pelcovits ACWDT) at 30 & Appendix IV.

[21] *See* SXW3_Native_0016 (RESTRICTED)

[22] With respect to the calculation of the adjustment factor Dr. Pelcovits relies upon a total of 18 subscription services (7 non-interactive and 11 interactive) for each of his methods of calculating the interactivity adjustment. SoundExchange Trial Ex. 2 (Pelcovits ACWDT) at 25, 27. This

41. The purpose of Dr. Pelcovits' hedonic regression analysis is to understand the features that affect subscription rates.[23] Because his regression analysis is a study of subscription rates, any estimate of a reasonable royalty based on it suffers from the fundamental flaw that non-interactive Internet radio is primarily an advertising-supported business, not a subscription business.

42. Hedonic regression is a statistical analysis of prices that seeks to explain prices as a function of product features. For example, a hedonic regression of car prices might use as explanatory variables horse power, weight, wheel base, and indicator variables for the presence of luxury items like leather seats. In his hedonic regression analysis, Dr. Pelcovits sought to quantify the effect of different product features on Internet radio subscription prices. In particular, he sought to measure the value consumers place on interactivity.

43. Dr. Pelcovits never explains why this is relevant; and, in fact, it is not. The key assumption underlying Dr. Pelcovits' analysis is that royalties should be the same percentage of revenue for interactive and non-interactive services. Dr. Pelcovits estimates that for interactive services, royalties are 47.4% of revenues. If a non-interactive Internet radio company were a subscription service, then Dr. Pelcovits' logic would imply that royalties per subscriber should be the same 47.4% of the subscription price. Since Dr. Pelcovits estimates an average subscription fee of $4.13, his logic

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number of observations is small, particularly in light of the relatively large number of explanatory variables.

[23] Dr. Pelcovits' regression model cannot analyze the value of interactivity for advertising based Internet radio services because doing so "would be just wrong…. it would say that there is no willingness to pay and no value to the music in an advertiser-supported service." Direct Hearing Tr., April 20, 2010, at 282:10-22. Dr. Pelcovits again ignores the realities of the non-interactive market by relying on a model that is incapable of accounting for the predominant source of revenue.

dictates royalties *per subscriber* of 0.474 x $4.13 = $1.96. (To get the royalty *per play*, one would divide the royalty per subscriber by an estimate of the number of plays per subscriber.)[24]

44. But this is not what Dr. Pelcovits does in his estimate that uses regression analysis. Rather than taking 47.4% of $4.13, he takes 47.4% of $4.78. Obviously, taking 47.4% of this higher number generates a higher royalty per subscriber and, in turn, a higher royalty per play.[25]

45. The question one needs to ask is what the $4.78 represents. Dr. Pelcovits computes it as $13.30 - $8.52. The $13.30 is the average price (adjusted for downloads) of interactive services. The $8.52 is the regression coefficient on the interactivity variable in Dr. Pelcovits hedonic regression. That is, it is his estimate of the value consumers place on interactivity. The $4.78 is, therefore, Dr. Pelcovits' estimate of what the average price would be of the interactive services in his sample if those services were not interactive. It is different from $4.13, the average price of non-interactive services in his sample, because the interactive services have features besides interactivity that, according to Dr. Pelcovits' regression estimates, consumers value.[26]

46. The whole purpose of Dr. Pelcovits' hedonic regression is to compute the $4.78 – i.e., the average price of what the average subscription price for interactive

[24] Dr. Pelcovits' calculations presume 563.36 plays per subscriber to non-interactive services. Thus, the calculation of a royalty rate per play that would result in royalties per subscriber of $1.96 (which in turn is 47.4% of the average subscription price) is $1.96/563.36 = $.0035.

[25] The royalty per subscriber becomes 0.474 x $4.78 = $2.26, which in turn produces a royalty per subscriber of $2.26/563.36 = $0.0040.

[26] Of course, Dr. Pelcovits' regression equation that does not include his suspicious use of fixed effects discussed below suggests that the value consumers place on interactivity is greater than the difference in the average subscription prices for interactive and non-interactive services.

services would be if they were not interactive. I cannot see any possible relevance to this proceeding for this calculation. Even if non-interactive Internet radio was entirely a subscription business and subscription rates determined revenue per subscriber, the appropriate input into a benchmark analysis like Dr. Pelcovits' would be the subscription rates that non-interactive services actually charge. What the interactive services would charge if they were not interactive simply does not matter.

47. Even if it were appropriate to use subscription prices to measure revenues per user for a non-interactive service, the Copyright Royalty Judges should disregard Dr. Pelcovits' irrelevant regression analysis.

B. Fixed Effects Eliminate Observations

48. Even if a regression analysis like Dr. Pelcovits' were relevant to this proceeding, the details of how Dr. Pelcovits did the analysis are highly suspicious. Specifically, the regression Dr. Pelcovits uses includes a set of what he claims are "fixed effects" variables. In Pelcovits' regression analysis these are indicator variables for the following services: Kazaa, Digitally Imported, Classical Archives, Pasito Tunes, and IMesh.[27]

49. When Dr. Pelcovits runs the regression without these five "fixed effect" variables, the resulting estimated royalty rate drops substantially. In this scenario, the estimated value of interactivity increases from $8.52 to $10.55, causing the estimated royalty rate to decline almost 36% from $0.0036 to $0.0023.[28]

[27] SoundExchange Trial Ex. 2 (Pelcovits ACWDT) at 27.

[28] The estimated value of the interactivity coefficient (10.55) is reported at SXW3_00003734. The royalty rate of $0.0023 is calculated as follows: ((13.30 – 10.55)/13.30) *0.5101 * $0.02194.

50. While "fixed effects" is a widely-used econometric technique, it is generally used for large panel data sets. (A panel is a data set with cross-sectional observations at different points in time). Moreover, fixed effects are indicator variables that capture unobserved characteristics whose values do not change over time. Dr. Pelcovits' data set, however, is a single cross-section, not a panel with cross-section and time series data.[29] Some of his "fixed effects," which are simply indicator variables for single observations, are econometrically equivalent to discarding these observations.[30]

51. Discarding observations for anything other than completely compelling reasons is a highly suspicious practice because it creates the opportunity for an econometrician to "put his thumb on the scales." The effect of discarding these observations has the effect of substantially increasing Dr. Pelcovits' estimate of a reasonable rate. Even if regression analysis of the determinants of subscription prices could be useful in this proceeding, the Copyright Royalty Judges should disregard his fixed effects estimates because the methodology in this context is inherently subject to manipulation to obtain a desired result – which is what appears to have happened here.[31]

[29] Time-series data are data for a single entity at different times. With cross-sectional data, there is a single observation on multiple entities. A panel (or time series cross section data) has multiple observations (at different times) on multiple entities. The number of games each major league baseball team won in 2009 is a cross-section. The number of games won by a single team over all the years of its existence is a time series. A data set containing the number of wins each year for each team is a panel.

[30] This point is a basic property of the "least squares" principle underlying regression analysis. With a dummy variable for a single observation, the value of the dummy can be selected to fit the observation perfectly. The remaining coefficients can then be selected to minimize the sum of the squared residuals for those observations, which results in the same coefficients as one would estimate by running the regression just with those observations.

[31] I would further add that Dr. Pelcovits has not provided any confidence region around his result. Had he done so with conventional methods, he would have found that the 95% confidence interval creates a range of royalty rates from $0.008 to $0.00004. *See* Exhibit 6. This would encompass rates that are almost triple what SoundExchange proposes, to rates that are a fraction

VIII. THE WSA AGREEMENT BENCHMARKS ARE TAINTED BY THEIR POSSIBLE EFFECT ON THIS PROCEEDING

52. Like the "Interactive Services Approach," Dr. Pelcovits "WSA Agreement Approach" suffers from numerous flaws as set forth below.

A. SoundExchange Has Excluded Evidence Of The Most Relevant WSA Agreements

53. Under the alternative "WSA Agreement Approach," the "benchmark rates" are rates that were set out in agreements between SoundExchange and webcasters covered by the compulsory license. Because these agreements relate to the compulsory license at issue here, Dr. Pelcovits argues that they are so directly comparable that no adjustment to them is necessary. As Dr. Pelcovits acknowledges, these rates are imperfect benchmarks because their possible effect on this proceeding can distort them. As I understand it, rate agreements between the parties under the WSA are by default non-precedential but can, by joint agreement of the parties, be deemed precedential. It is apparent that SoundExchange allowed the WSA Agreements with NAB and Sirius XM to be precedential, since Dr. Pelcovits could not use them otherwise.

54. As a purely hypothetical matter, SoundExchange might have agreed to lower rates with other parties and excluded evidence from those agreements from this proceeding. As a matter of economics, agreements that SoundExchange excluded are more reliable evidence of what SoundExchange would willingly accept in an unregulated market, as they are free of the influence of the overlay of this proceeding. The fact that SoundExchange declined to exclude the use of the agreements on which Dr. Pelcovits'

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of those proposed by Live365. Moreover, the small numbers of degrees of freedom (due to the combination of a small number of observations and a large number of variables) means that the conventional method for computing confidence regions might understate the range.

relied creates the presumption that it must have believed that the rates would help its case. SoundExchange's option to exclude rates implies that the rates arrived at in agreements that are allowed to come into evidence are biased upward as estimates of rates that SoundExchange would willingly accept in the market.

B. The Precedential WSA Agreements Enable The NAB And Sirius XM To Raise Their Rival's Costs

55. A notable feature of the WSA agreements for 2009-2015 is that SoundExchange accepted rates lower than the statutory rates to which it was entitled for 2009-2010. As a matter of economics, one needs to consider what it got in return for this concession. Dr. Pelcovits acknowledges this point, but then dismisses the need to adjust the 2011-2015 rates.[32] He argues that SoundExchange accepted lower rates than it otherwise would have to induce early settlement. In addition to being entirely speculative, the argument fails to address why the inducement took the form of lower rates in 2009-2010 rather than later on.[33] SoundExchange had available to it a variety of contractual terms to induce early settlement. Since SoundExchange could have insisted on the statutory rates for 2009 and 2010 and presumably would have preferred them all else equal, it must have insisted on something in return for the concession. The obvious hypothesis to consider is that SoundExchange got higher rates for 2011-2015 than it otherwise could have. Dr. Pelcovits does not provide any alternative hypothesis for what SoundExchange got for its concession.

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[32] *See* SoundExchange Trial Ex. 2 (Pelcovits ACWDT) at 20-2.

[33] I note that the 2011 rates for both the NAB Deal ($0.0017) and the Sirius XM deal ($0.0018) are lower than the statutory rate for 2010 ($0.0019). *See* SoundExchange Trial Ex. 2 (Pelcovits ACWDT) at 20.

56. As a matter of economics, one needs to consider why it was mutually beneficial for SoundExchange, NAB and Sirius XM to structure their deals with relatively low rates for the first years and higher rates thereafter. A natural possibility to consider is that they recognized that the rates they set might then become a benchmark that the Copyright Royalty Judges would set for companies that compete with the terrestrial broadcasters represented by NAB and with the satellite radio service provided by Sirius XM. The fact that the parties consented to letting the rates be precedential is consistent with this explanation.

57. As a matter of economics, an increase in the price of an input generally lowers a company's profitability and is therefore harmful to its interest. There is, however, an exception to this principle. A company can benefit from an increase in the price of an input if its rivals use the input more intensively than it does. The broad theory underlying this principle is called "Raising Rivals' Costs."[34]

58. I have examined the 10-K reports submitted by Sirius XM, Clear Channel and a number of major radio broadcasters. All cite Internet radio as a competitive threat to their business.[35] Given terrestrial radio stations do not pay royalties for over-the-air broadcasts and Sirius XM royalties in 2010 are 7% of revenue increasing to 8% of revenue in 2012,[36] royalties account for a far larger share of the total costs of companies

[34] Salop and Scheffman, "Raising Rivals Costs", AEA Papers and Proceedings, May 1983, pp. 267-271; Krattenmaker and Salop, "Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power over Price," The Yale Law Journal, vol. 96, Number 2, December 1986.

[35] Clear Channel 2009 10-K, p.3; Sirius-XM radio 2009 10-K, p.9; Salem Communications 2009 10-K, p.10; Citadel Broadcasting Corporation 2009 10-K, p.11; Cumulus Media 2009 10-K, p.8; Entercom Communications Corporation 2009 10-K, p.1.

[36] *See* 37 C.F.R. § 382.12.

which rely on revenues from non-interactive services for the bulk of their revenues.[37] The substantial cost that royalties represent for non-interactive services raises the inherent possibility that terrestrial broadcasters and Sirius XM have engaged in raising rivals' cost strategy to disadvantage their Internet radio competitors.[38]

59. Pandora can be used as an example to demonstrate that raising rival costs could be a viable strategy. Pandora's revenue per play in 2009, $[redacted] is approximately equal to the 2011 WSA rate, $[redacted][39], on which Pelcovits relies. At the WSA royalty rate, Pandora would only have $[redacted] per play, or [redacted]% of its total revenue, to cover all of its remaining costs and earn a reasonable profit. As it would be highly unlikely to be able to do so, it may well be eliminated as a competitor to the companies that agreed to these WSA rates.

60. The above example makes clear the ability of NAB and Sirius XM to potentially raise rivals' costs through negotiations of royalty rates. In addition, it demonstrates that even the lower WSA benchmark relied upon by Pelcovits would be rejected by Pandora and other non-interactive services because of their likely unprofitability at these rates. This indicates that the use of this benchmark is flawed.

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[37] Pandora has reported royalties accounting for between 56% and 70% of revenues ("Pandora: Last gasp for Internet radio can't be further prolonged", betanews.com, 8/19/2008; "Pandora rises out of the streaming music rubble," CNNMoney.com, 2/18/10; "The Contents of Pandora's Box = $$$$," themusicvoid.com).

[38] This is not just a theoretical argument; there have been allegations that competitors in this industry have entered into agreements to raise the cost to its competitors for this exact royalty. *See, e.g.,*"Cuban Says Yahoo!'s RIAA Deal was Designed to Stifle Competition," RAIN Newsletter, June 24, 2002, available at http://www.kurthanson.com/archive/news/062402/.

[39] SoundExchange Trial Ex. 2 (Pelcovits ACWDT) at 4.

C. As A Representative Of Competitors, SoundExchange's Incentive Is To Demand Higher Royalties Than The Members Could Negotiate Individually

61. As a former antitrust official, another aspect of the WSA agreement rates that I consider important is that a single entity (SoundExchange) negotiated the rate on behalf of competing sellers. Absent an explicit antitrust exemption, I would expect, based on my enforcement experience, that such joint negotiations would be *per se* criminal violations of the antitrust laws. The rationale for the *per se* ban is the strong presumption that such coordination poses a risk of increased prices. This expectation is widely accepted as a very general principle of economics, but it is not merely an economic principle. The antitrust laws embody the principle, and wide acceptance of the principle is why cartel enforcement has been a top priority of the Antitrust Division of the Department of Justice in both Republican and Democratic administrations. It is also the reason that ASCAP and BMI are subject to rate courts.

62. Apparently aware of this issue, Dr. Pelcovits seeks to dismiss it by pointing out that the royalty rates for custom radio services, which the record companies negotiated individually, are above those in the WSA agreements. The argument is not persuasive because it is not an "apples-for-apples" comparison. To the extent that customization either adds value or alters the extent to which the service substitutes for or promotes the purchase of music, both individual record companies and a collective body of record companies would charge higher rates to custom radio services than to non-custom services. To determine the effect of joint negotiation on royalty rates, one would need to compare the rates negotiated by a collective to the individually-negotiated rates with the same customer. We do not have the data to make that comparison.

63. If there was not a compelling reason to believe that a collective of competing record companies would seek a higher rate than would the individual companies, there would be no reason for a proceeding such as this. The entire premise behind giving buyers recourse to a rate court is that the collective will seek to charge more than its members could individually.

IX. CONCLUSIONS

64. Dr. Pelcovits' estimate that non-interactive Internet radio companies could reasonably pay a royalty of $0.0036 per play is based on his estimate that they can earn revenues per play of $0.0073, an estimate that he obtains by assuming that non-interactive radio is a subscription business. However, non-interactive streaming is primarily an advertising-supported business, and the revenues per play from non-subscribers are likely far less than $0.0073 per play. Indeed, the revenue per play (averaged over plays to subscribers and non-subscribers) for the non-interactive radio industry is likely less than $0.0036, to say nothing of the $0.0073 underlying Dr. Pelcovits' "Interactive Services" benchmark. Dr. Pelcovits provides no empirical foundation for how much (if any) additional revenue per play Internet radio services will be able to generate. The Copyright Royalty Judges should disregard the "Interactive Services" benchmark as an estimate of what willing buyers would accept because: (1) it is implausible on its face, and (2) its derivation ignores the key economic fact that subscribers are not the sole (or even the primary) revenue source for Internet radio, among other things discussed above.

65. The "WSA Agreement" rates, which are below those proposed by SoundExchange, are themselves inflated measures of an appropriate royalty rate because: (1) they are rates set with a collective seller; (2) SoundExchange's right to decide which agreements to allow into evidence makes those that are entered into evidence a biased sample; and (3) the buyers, who in any event had an incentive to raise their rivals' costs, appear to have been induced to accept higher rates for 2011-2015 with rates below those to which SoundExchange was legally entitled for 2009-2010.

66. For these and the other reasons articulated above, Dr. Pelcovits fails to provide support for the proposition that the rates SoundExchange proposes are reasonable under the statutory standard. Thus, his analysis should be disregarded.

INSERT SIGNATURE PAGE

Exhibit 1

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Summary

Michael A Salinger is a managing director in LECG's Cambridge office and a professor of economics at the Boston University School of Management, where he has served as chairman of the department of finance and economics. Prior to joining LECG, Dr. Salinger served two years as director of the Bureau of Economics with the FTC, overseeing approximately 70 PhD economists and additional professional staff. Prior to his tenure at Boston University, he was an associate professor at Columbia University Business School and a staff economist in the Bureau of Economics, as well as serving on the editorial boards of the *Review of Industrial Organization* and the *Journal of Industrial Economics*. Dr. Salinger has consulted for private organizations and a variety of worldwide government agencies including the EPA, the Federal Trade Commission, the board of governors of the Federal Reserve, and the Australian Competition and Consumer Commission. He has published articles on such issues as the structural determinants of market power, the statistical properties of firm growth, and the competitive effects of tying and vertical mergers. Dr. Salinger holds a PhD in economics from the Massachusetts Institute of Technology and an undergraduate degree from Yale University.

Current Positions

LECG (2007) Managing Director

Boston University School of Management (1990) Professor of Economics (Associate Professor 1990-2001), W. Everett Lord Distinguished Faculty Scholar (2007-), Chairman of Finance and Economics Department (2000-2004), Faculty Director of Undergraduate Program (1999-2000)

Previous Positions

United States Federal Trade Commission, Director, Bureau of Economics, (while on leave from Boston University), 2005–2007

Sloan School of Management, MIT, Visiting Associate Professor of Applied Economics, (while on leave from Boston University) 1997-1998

Columbia University Graduate School of Business, Associate Professor of Economics and Finance (Assistant Professor 1982-1987)

United States Federal Trade Commission, Economist, Bureau of Economics, Antitrust Division (while on leave from Columbia), 1985-1986

Academic Publications

Keith A. Anderson, Erik Durbin, and Michael A. Salinger, "Identity Theft," *Journal of Economic Perspectives*, Volume 22, 2008, pp. 171-192.

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"Concluding Remarks for Energy Markets in the 21st Century: Competition Policy in Perspective," Washington, DC, April 12, 2007.

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"Moneyball and Price Gouging," Boston Bar Association Antitrust Committee, Boston, MA, February 27, 2006.

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"Is It Live Or Is It Memorex? Models of Vertical Mergers and Antitrust Enforcement Association of Competition Economics (ACE) Seminar on Non-Horizontal Mergers," Competition Commission, London, UK, September 7, 2005, and Fondation Universitaire, Brussels, Belgium September 8, 2005.

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Report entitled "Pricing Flexibility in Exchange Access Reform" submitted by GTE, reply comments. Federal Communications Commission (CC Docket No. 96-262 et al.) (1997).

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Reports for Turner Broadcasting on the treatment of affiliate transactions in cable television price regulations (1994).

Written testimony on behalf of Devotional Broadcasters before the Copyright Royalty Tribunal. Testimony concerned appropriate procedures for allocating royalties paid by cable operators among different classes of programs on retransmitted broadcast signals (1993).

Deposition testimony for Long Lake Energy Corp. in monopolization suit against Niagara Mohawk Corporation. Testimony concerned appropriate market definition (1991).

Affidavit concerning class certification in a class action suit against bottlers of Coke and Pepsi. Affidavit argued that a conspiracy to raise the price of colas sold on promotion to grocery stores affected soft drink prices in general (1989).

Testified as to damages on behalf of Record Club of America in a breach of contract suit against United Artists. Testimony concerned distinction between marginal and average cost and econometric projection of sales (1988).

Other Professional Activities/Distinctions

Participant, Academic Consultants Meeting on Non-Traditional Financial Services, Federal Reserve Board, April 16, 2008.

Presenter, Fundamentals of Antitrust Economics, American Bar Association Antitrust Section Spring Meeting, 2007, 2008.

Editorial Board, *Journal of Industrial Economics*, 2002-2006, (Associate Editor, 1996-2002).

Editorial Board, *Review of Industrial Organization*, 2002-2005.

Special Consultant, National Economic Research Associates, 1994-2005.

Member, Science Advisory Board/Illegal Competitive Advantage, United States Environmental Protection Agency, 2004.

Broderick Prize for Service to Undergraduate Community, Boston University, 2004.

Who's Who in America (first listing in 2003).

Principal Investigator: "A Statistical Mechanics Approach to Coase's Theory of the Firm," National Science Foundation Grant SES-0113103, 8/1/01-7/31/02.

Courses Taught

Boston University
Undergraduate: Modeling Business Decisions and Market Outcomes (course designer and director), Probability and Statistics, Business History
Masters: Quantitative Methods, Managerial Economics, Health Care Economics, Health Care Finance, Economics of Strategic Planning
Executive: Microeconomics (Korean Executive MBA), Macroeconomics
Doctoral: Cross-disciplinary Theory and Research

MIT
MBA: Microeconomics, Economics of Strategic Planning

Columbia:
MBA: Business Economics, Economics of Strategic Planning, Econometrics, Industrial Organization
Doctoral: Microeconomics, Industrial Organization

Exhibit 2

RESTRICTED – Subject to Protective Order in Docket No. 2009-1
CRB Webcasting III

Exhibit 3

RIAA Exhibit No. 108 DP

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ESTIMATION OF ECONOMIC VALUE

OF WEBCASTER STATUTORY LICENSES

APRIL 2001

TABLE OF CONTENTS

1. Introduction

It is our understanding that in the Digital Millennium Copyright Act of 1998 (DMCA) Congress afforded webcasters compulsory (or statutory) licenses 1) to transmit copyrighted sound recordings over the Internet in a radio-like format and 2) to make multiple "ephemeral" copies of the copyrighted sound recordings for use in connection with these transmissions. To be eligible for these compulsory licenses, webcasters must comply with various statutory conditions, including the payment of a reasonable royalty.

A webcaster retains the option to negotiate a royalty with individual copyright owners of sound recordings or with the Recording Industry Association of America (RIAA), which represents most of these copyright owners. For those entities that do not negotiate a royalty, the DMCA directs a panel of arbitrators (the Copyright Arbitration Royalty Panel or CARP) to determine the royalty rates that should be paid for the webcaster compulsory licenses. The CARP must set rates and terms that "most clearly represent the rates and terms that would have been negotiated in the marketplace between a willing buyer and a willing seller."

RIAA has negotiated agreements with more than 20 webcasters setting forth rates and terms for the DMCA statutory licenses. Based on those agreements, RIAA intends to request the CARP to adopt the following rates for the period 10/98 through 12/02:

- Webcasters may choose 15% of revenues attributable to music or $.004 per performance, with a long play surcharge of $.0008 per minute for performances over five minutes.
- These rates would cover any non-syndication business model permitted by the DMCA.
- Syndicators (those webcasters that provide music programming to third party websites) would pay $.005 per performance, with a long play surcharge of $.001 per minute for performances over five minutes.

RIAA has sought SPG's opinion as to whether the proposed rates are consistent with the rates that SPG would recommend, based on principles that SPG routinely employs in advising other suppliers on pricing issues. The criteria SPG used to determine if the rates are reasonable are: 1) the price should reflect the economic value of the product; and 2) the price is set lower than the economic value in order to provide an incentive for the buyer to purchase the product.

2. Economic Value Estimation® Methodology

2.1. Economic Value Estimation®

Buyers judge prices in terms of the economic value represented by the product (or service) being considered. In transactions between two businesses, the value of a product is the incremental gross margin (incremental revenues minus incremental costs) that accrues to the purchaser. The price of a product should reflect the value that product delivers to a particular customer segment.

The technique that Strategic Pricing Group, Inc. (SPG) employs to quantify the economic value of our clients' products is called Economic Value Estimation® (EVE®). The process provides an identification of relevant competitive alternatives, a basis for framing the value of the offering to a customer, and a basis for setting a price that would be considered fair in a willing buyer/willing seller environment. We have employed Economic Value Estimation® at Strategic Pricing Group since the firm began executing consulting engagements in 1994. Since that time, we have used the technique with virtually all of the approximately 250 training and consulting clients with whom we have worked.

2.2. Brief History of Value Analysis Techniques

Economic Value Estimation® (EVE®) is SPG's name for a widely accepted analytic technique to determine the economic value of a product to a customer when compared to that customer's next best alternative for the same or similar product. These techniques began with value analysis and value engineering, developed in the late 1940s within the General Electric Corporation. At GE,

product development teams generally used these techniques to lower costs while maintaining prescribed levels of product performance. The leader in this effort was Lawrence D. Miles, whose book *Techniques of Value Analysis and Engineering* was published in 1961 (Miles, 1961).

Value analysis and value engineering flourished as an engineering discipline in the 1950s, with the rise of several certification programs, professional associations, and consulting firms devoted to the practice (Falcon, 1964). During this period, similar techniques also were adopted by purchasing departments as a tool for setting product specifications and working with suppliers to extract greater value from their offerings. From there, the techniques made their way into sales and marketing organizations, where providers of higher value offerings often used them to set and justify the premium prices they charged (Hanan, 1973).

Corporations like the DuPont Company and Caterpillar were among the first to adapt these techniques to use in developing marketing and pricing strategies (Kotler, 1980). The evolution in this area is detailed in marketing literature.[1] A survey of 80 of the country's largest business-to-business industrial firms conducted in the early 1990s showed that roughly 40% had employed economic value analysis techniques within the previous year (Anderson et al).

2.3. Price Should Reflect the Economic Value Delivered

The value that is key to developing effective pricing strategy in competitive markets is what economists call "exchange value" and what marketers call "economic value-to-the-customer." We commonly refer to this as simply "economic value" and, as mentioned above, the process of analyzing it as "Economic Value Estimation®." The technique considers the economic impact of

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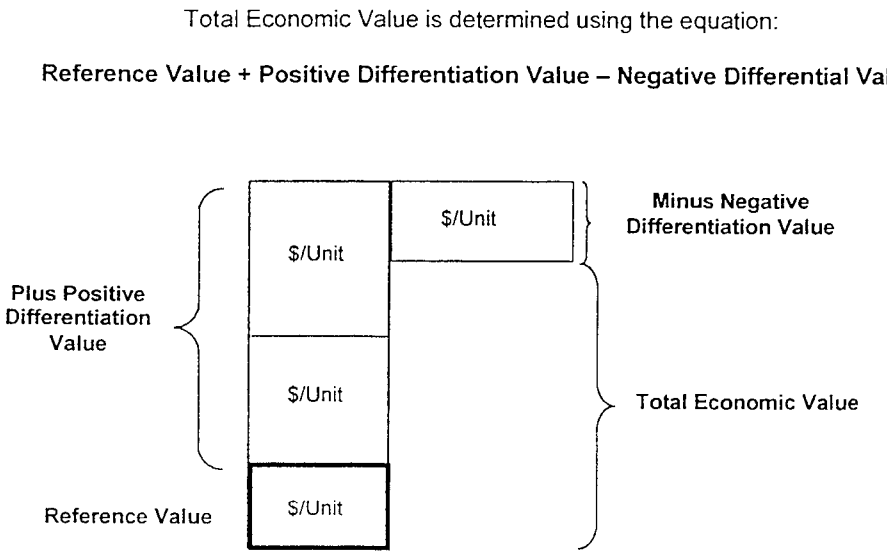
[1] Benson Shapiro and Barbara B. Jackson of Harvard Business School in "Industrial Pricing to Meet Customer Needs," *Harvard Business Review* 56, no. 6 (November - December 1978), John Forbis and Nitin Mehta of McKinsey and Company in "Value-Based Strategies for Industrial Products," *Business Horizons* 24, no. 3 (May-June 1981).

one product in comparison to the next best competitive alternative. A pictorial description is a useful reference to understand the basic components of an EVE® (Figure 1).

Figure 1: Economic Value Estimation®

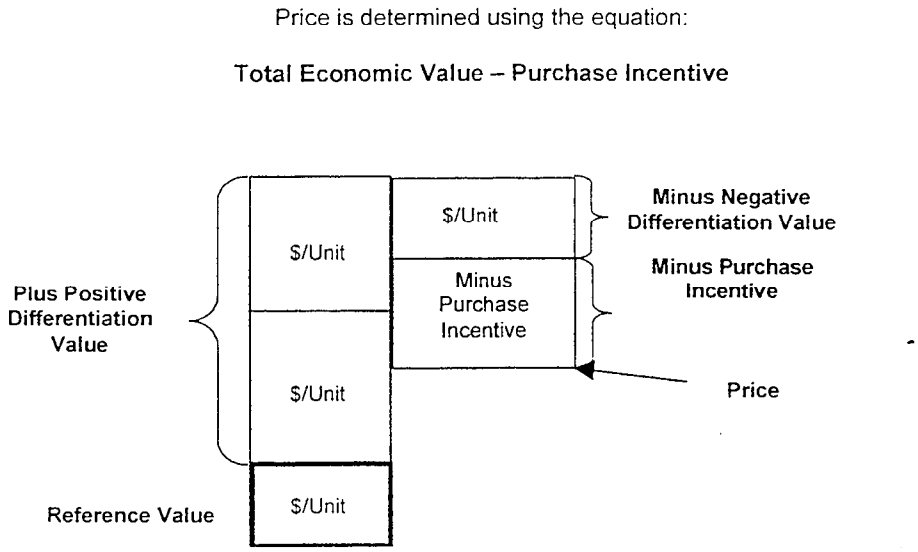


As Figure 1 depicts, the economic value of a product is the price of the buyer's best alternative (called the *reference value*) plus the value of whatever differentiates the product from the alternative (called *the differentiation value).* Differentiation value may have both positive and negative elements. Differentiation value is quantified in terms of incremental revenue and/or cost changes (either positive or negative) for the customer due to the product compared to the alternative. Put another way, *reference value* is the cost of the competing product that the buyer views as the best alternative for this one. *Differentiation value* is the economic impact to the buyer of any differences between the seller's offering and the reference offering. It is important to note that the buyer is the entity buying directly from the seller, as opposed to the ultimate end-user. In this case, the buyer is the webcaster.

Total economic value is the maximum price that a willing buyer would be willing to pay for particular goods or services, assuming that they were fully informed about the market and seeking the best value. Few buyers are willing to pay all that a product is worth (its total economic value) especially if there are multiple competitors offering a good alternative for a lower price. Sophisticated business buyers often demand an economic value analysis that quantifies the benefits of high-priced brands or that shows how low-priced brands can save more than the value of the benefits given up. Charging the full value does not provide a buyer with an incentive to buy one product instead of its alternative. Prices should be set far enough below the total economic value to provide the customer with an incentive to buy the higher priced product that delivers higher value over the lower priced alternative. The difference between the total economic value and the price is called the purchase incentive.

Conversely, only a small percentage of business buyers want to pay the absolute lowest price in the market, especially if paying more will provide them with positive economic benefit above the lowest priced alternatives. By setting the price between the reference value and the total economic value, the buyer pays more for the added value delivered yet still has the incentive to buy the higher-priced/higher-value offering. Figure 2 shows how prices should be set relative to the economic value while providing a purchase incentive to the buyer.

Figure 2: Set Price Relative to Economic Value While Still Providing a Purchase Incentive



2.4. Summary of Steps in Constructing an Economic Value Estimation®

The implementation of EVE® methodology can be outlined as a series of steps which, generally applied, will provide the foundation for estimating economic value for a product.

Step 1: Identify the customer's next best competitive alternative and the cost of that alternative (i.e., the reference value).

Step 2: Identify all factors that differentiate the product from the competitive alternative and determine the value to the customer of these differentiating factors.

Step 3: Sum the reference value and the positive and negative differentiation value to determine the total economic value.

Step 4: Determine the selling price, recognizing that the product must usually be priced below economic value as an incentive to purchase.

3. Analytic Framework

Our analysis is built upon a series of economic foundations that are relevant to the webcasting statutory licenses and the webcasting industry.

3.1. Nature of Licenses Being Priced

At issue is the price that each webcaster would pay for the DMCA statutory licenses in a free market. The payments would be made to RIAA on behalf of all sound recording copyright owners. The licenses in question have the following characteristics:

- The nonexclusive licenses cover streaming over the Internet any and all copyrighted sound recordings (the several hundred thousand created since 1972 and those created in the future), in accordance with DMCA statutory conditions (i.e., non-interactive, radio-like format).
- Licenses cover only the sound recording copyright and not the underlying musical work, which is licensed by ASCAP, BMI or SESAC.
- Because RIAA will be responsible for collecting royalties from webcasters and distributing them to individual copyright owners, the licenses allow webcasters to avoid incurring the transaction costs of negotiating with the copyright owners and locating and paying copyright owners and artists individually.
- The licenses cover a perpetual term – i.e., rates could change every two years but licenses remain in effect absent Congressional action and copyright owners have no right to revoke.

3.2. Webcasters are Investing Now for Future Economic Benefit

The webcasting industry is in its early stages of development, as evidenced by the highly fragmented market, variations in the costs of inputs and revenue sources, and substantial investment webcasters are making today to grow their audience and their brand. As of December 2000, publicly held webcasters such as NetRadio ⟨NETR⟩, Artist Direct ⟨ARTD⟩, Launch Media ⟨LAUN⟩ are experiencing operating losses from (–169%) to (–795%) of revenues (from Multex Market Guide, year 2000 income statements). Given the current state of profitability in webcasting, which is negative, it is apparent that webcasters are not entering this business because they find the immediate returns attractive. They are investing now in order to build a customer base and business model that they believe will be financially rewarding in the future.

3.3. Economic Value Must be Estimated for a Future Point of Viability

In estimating economic value, we must consider the economic impact on the buyer of the product over the lifetime of that product to that buyer. For the reasons stated above, we can see that the economic benefits of the licenses to the webcaster will be realized in the long-term. The value of the statutory licenses to the webcaster must be estimated at a future point in time when a) the webcasting industry is economically viable and b) a typical webcaster is operating at a sustainable scale. Determining the economic value at some future point of viability is consistent with our EVE® methodology and generally accepted pricing principles.

3.4. Industry Viability

The concept of economic viability is central to the ability of a given industry to sustain competitive rates of return in the long run. An industry that has reached or is approaching viability will be marked by convergence around profitable business models and abandonment of those models that are deemed unsustainable over the long run. Key enabling technologies will become more mature leading to the creation of de facto standards as industry leaders adopt the technologies on larger and larger scales. Widespread adoption of these technologies will lead to increased demand for technology inputs (such as bandwidth), and competition between

technology suppliers to meet this demand will result in more predictable and lower costs for industry participants.

After a period of rapid growth, the rate of user adoption will slow, allowing competing webcasters to focus their marketing efforts on the substantial number of existing end-user customers. Improvements in technology will also make the industry more attractive to end-users who were hesitant to participate in the industry in its early stages. As market leaders emerge, they will achieve efficiencies in their sales and marketing investments due the strength of their brands. Additionally, in media businesses, the size of their audiences will make them more attractive to advertisers who seek efficient means to reach their target audiences. In the webcasting businesses these marketing efficiencies will manifest themselves as follows: With increased and improved measurement of Internet audience size and efficacy of advertising (especially audio advertising), advertisers' acceptance of the Internet as a viable medium will increase. Thus, advertisers will invest more of their advertising dollars in this medium.

3.5. Webcaster Viability

The webcasting industry, like others, will eventually consolidate into a small number of large participants. As in other industries, successful webcasters that reach a sustainable scale will experience cost and revenue advantages that may be difficult for competitors to match. Small webcasters which fail to attain a certain number of listeners will likely be unprofitable and will either go out of business or will be acquired by a larger company in order to drive traffic to the acquirer's website or for other strategic reasons. As the webcasting industry consolidates, it will be possible for some webcasters to achieve a sustainable size and become economically viable, producing competitive returns on their business.

The royalty rate for the statutory licenses today should be set at a rate consistent with long-run viability, despite the fact that royalty rates may be changed every two years. Providing lower royalty rates while the webcasting industry grows towards viability may be the most desirable pricing for webcasters, but it is certainly not a pricing strategy that a willing seller would agree to

in a free market. If it were, landlords would give Internet startups free or discounted rent, broadband suppliers would give free or discounted network access, equipment suppliers would give free or discounted equipment – all in return for promises to pay more when and if the startups became more profitable. We do not see this in free markets of willing buyers and willing sellers and we have never recommended such pricing to a client.

There is a further problem with setting a royalty rate lower than what would be reflected through consideration of the future point of viability. Under-pricing major resources to firms in an industry lengthens or prevents entirely the shakeout of weaker firms and the consolidation of the remainder into viable, profitable competitors. It is well known that subsidized industries have a tendency to remain unprofitable, thus continuing to require the subsidy.

4. Statutory Licensing Royalty Rate Analysis

Strategic Pricing Group applied the same methodology for constructing an Economic Value Estimation® as discussed above to estimate the value of the statutory licenses to the webcaster who has reached sustainable scale at the point of viability. The first thing we considered was the competitive alternatives to the statutory licenses. Next, we estimated the economic value of the statutory licenses on a webcasters' business. Based on this economic value, we then suggested an incentive for the webcaster to purchase the statutory licenses. Finally, by subtracting this incentive from the total economic value, we arrived at a reasonable rate for the statutory licenses. We have concluded that RIAA's proposed prices are reasonable relative to the economic value of the DMCA statutory licenses to the licensees.

4.1. Traditional (Internet-Only) Webcaster Economic Value Estimation®

Internet-only webcasters program channels -- typically by genre (e.g., World, Alternative, and Oldies) -- for consumer end-users. The source of the music is the copyrighted sound recordings created by record companies and recording artists, which are encoded and transmitted over the Internet. Examples of Internet-only webcasters include NetRadio and Spinner (now owned by AOL/Time Warner). Outlined below is a detailed summary of our analysis.

Step 1: Identify the reference value of the customer's next best competitive alternative and the cost of that alternative (i.e., the reference value).

The first step in quantifying the economic value of a product is to identify the cost of the competitive product that the webcaster customer views as their next best alternative. After identifying the next best alternative, we restate the cost of this alternative in terms of units of the product for which we are calculating economic value. This restated cost is the offering's reference value.

Webcasters' future growth depends upon three categories of inputs that are presently identifiable: 1) operational infrastructure; 2) bandwidth and associated technologies to support distribution; and 3) content. For an entity that intends to develop a portion or all of its business around the delivery of non-interactive performances of copyrighted sound recordings, there are several alternative means for acquiring and deploying the first two categories of inputs (operational infrastructure and distribution technology). For the third category (content), there are no competitive alternatives to the statutory licenses without negotiating with individual record labels. The statutory license offers access to all sound recordings created after 1972 without the need to negotiate with individual labels directly. Webcasters who want to stream these sound recordings without negotiating with each label have no alternative except to pay for the statutory licenses. Therefore, we conclude that there is no relevant alternative for a statutory license and the reference value is $0.

Step 2: Identify all factors that differentiate the product from the competitive alternative and determine the value to the customer of these differentiating factors.

Once the reference value is known, then the incremental positive and negative value delivered by a product can be calculated. This incremental value is quantified in the form of increased revenues or decreased costs that result from differences between the product and any competitive alternative. Sources of value may be subjective (for example, greater satisfaction in using the product) or objective (for example, cost savings or profit gains). The positive and negative values associated with the product's differentiating attributes comprise the differentiation value.

Differentiation value for a statutory license for sound recordings can be thought of in the following ways:

- The music's impact on the ability of a site to attract, grow and retain an audience and the corollary effects on the site's ability to sell more advertising and/or command higher rates for its advertising inventory.
- The attractiveness of the site's content or audience to other sites and the corresponding effect on the site's ability to generate referral fees, collect commissions, or generate licensing fees.
- For those sites engaging in e-commerce impact on gross margins through changes in customer buyer behavior such as purchase frequency, order size and/or choice of higher margin products.

In order to quantify the differentiation value of the statutory licenses to the webcaster, we calculated the incremental operating income (incremental revenues due to using the statutory licenses minus incremental and avoidable costs due to using the statutory licenses) of a successful webcaster at a future point of viability. This operating income is the value of the statutory licenses to the webcaster. To do this, we undertook a financial modeling process.

The relevant costs that must be considered in estimating value are those that are both incremental and avoidable. In the webcasting industry, the major implication of having no economically viable alternative for the statutory licenses to operate in the non-subscription streaming business (i.e., having a reference value of $0) is that all ongoing costs, including the ongoing fixed costs of the business of webcasting, must be considered avoidable and thus included in the value estimation. Over time, webcaster costs will decline on average due to industry maturity, webcaster efficiency and as a webcaster achieves economies of scale with growth. Costs will also decline as a webcaster becomes more experienced and efficient in operations, even if the business were to remain the same size. Further, some technology-related costs, such as bandwidth, show trends of decline over time, on a per unit basis as the industry matures and technology continually improves.

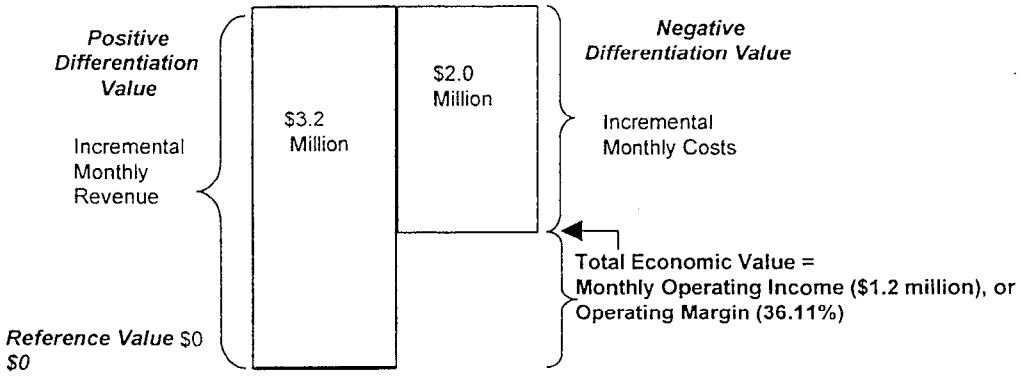
It is important to note that many webcasters will attempt to offer both DMCA-compliant and non-DMCA-compliant (interactive, exclusive license, etc.) programming. This type of webcaster will realize additional revenues and costs as they add other businesses. Our models consider only the part of the webcaster's business model related to streaming music covered under the DMCA. The analysis assumes a "stand-alone" business rather than a business with multiple business units. This is the most conservative assumption because the fixed costs of the business are not shared across multiple business units.

Step 3: Sum the reference value and the positive and negative differentiation value to determine the total economic value.

Once the differentiation value (in the webcaster's case, its potential operating income before paying for the statutory licenses) is quantified, this amount is added to the reference value of $0. The result is the total economic value of the statutory licenses to the webcaster. In this case, the economic value of the licenses to use copyrighted sound recordings is the webcaster's operating income (relevant revenues minus relevant costs). Using the modeling techniques described above, we determined a webcaster's monthly operating income at a future point of viability. Dividing this operating income by the webcaster's revenue, we arrived at the webcaster's projected operating margin at the point of viability (36.11%). A graphical depiction of the Economic Value Estimation® is shown in Figure 3.

Figure 3: Traditional (Internet-only) Webcaster Economic Value Estimation®

Figure 3 illustrates our analysis in Appendix 1A. The economic value of a statutory license to webcasters is the webcaster's monthly operating income. The operating income is the difference between the relevant and ongoing revenues and costs at a future point of viability.



Step 4: Determine the selling price, recognizing that products must usually be priced below economic value as an incentive to purchase.

The total economic value (reference value plus differentiation value) is the point of indifference for the informed purchaser. This is the price at which the buyer would be indifferent between one product and the next best alternative. When pricing the product based on its economic value, there must be some incentive for the purchaser to choose this offering. In this case, the total economic value is the webcaster's operating income (or operating margin) at the point of viability. If a webcaster had to pay statutory license fees equivalent to the total economic value, the business would just break even and there would be no profit remaining for the owner of the business. Therefore, the fee for the statutory licenses should be based on some portion of the value of the statutory licenses, which allows investors/owners to make a reasonable return on their investment. This is, in effect, the incentive for using the statutory licenses.

A webcaster's operating margin at the point of viability should enable the webcaster to cover its earlier operating losses, *and* to generate an acceptable rate of return. In our analysis, we calculate the range of operating margins a webcaster will need to earn at the point of viability to produce these acceptable returns. A company that can deliver a 25% annualized return is generally considered a successful business. We therefore conducted our analysis using returns of 20-30% over the life of the business. We assume a conservative growth rate between Year 5 and Year 10. Beginning in Year 10, we assume zero growth in earnings and give credit for the future earnings of the company. In conducting our rate-of-return analysis (shown in Appendix 2) we concluded that a webcaster could generate a 20-30% rate of return by earning an operating margin in the range of 8.43%-17.05%. By subtracting this return from the total economic value of the licenses, we arrive at the appropriate range for the statutory license royalty fee.

The final step in our analysis is to convert the license fee to a per performance rate. This conversion is shown in Appendix 3. The conversion uses a typical volume of 12 performances per hour. This volume is consistent with the average number of performances by radio stations, found in the Broadcast Data Systems Music Density Analysis. The resulting royalty rate is the range of $.0043 (allowing a 30% return) to $.0062 (allowing a 20% return) per performance.

Our analysis thus confirms that the rates RIAA is proposing for the statutory licenses are within the range of rates that would be obtained in a free market of willing buyers and willing sellers. The proposed rate is lower than the economic value of the statutory licenses, providing economic incentive to the webcaster. When considering the long-term returns of the webcaster business, it is not only possible for a successful webcaster to afford to pay the proposed statutory license fee, but also, the webcaster can achieve an attractive rate of return on this business that would be economically viable as the industry matures.

4.1. Other Types of Webcaster Services

There are variations on the Internet-only webcaster business model, including aggregators and syndicators.

Aggregators are 3rd party providers that aggregate content from multiple sources. They may aggregate non-broadcast (i.e., Internet-only channels) onto a single site or aggregate multiple terrestrial radio stations so that no single station has to make the large capital investment necessary to stream independently. The aggregator typically requires the listener to select the station's transmission (Internet-only or terrestrial) from among many other stations on the aggregator's website (e.g., Yahoo! Broadcast) and/or allows the listener to select the stream directly from the radio station's website (e.g., SurferNetworks).

Like the Internet-only webcaster, the aggregator business model derives revenue largely through advertising. Some aggregators, but not all, also charge the broadcasters a fee for their services. Relative to the webcaster, the aggregator experiences some marketing and programming cost efficiencies, but also some incremental technical and equipment costs. We believe that the long run differences in magnitude in the types of costs between Internet-only and aggregator services will be insignificant. For these reasons, we recommend charging the aggregators the same royalty rate as the Internet-only model.

Syndicators are businesses that provide music streaming services and technology to third-party websites, including retail sites (such as EddieBauer.com or PotteryBarn.com). Retail websites may purchase streaming music services from syndicators (such as Websound and Radioamp.com) in the form of "branded radio," with music selected to reinforce the brand image of the retailer. Music has long been used in off-line retail environments to add to the shopping experience. Studies have shown that music can influence buyer mood and purchase behavior, and it is generally believed that music can have a positive impact on shopping behavior (e.g., length of shopping time and purchase amount) and the retailers' revenues. Additionally, research indicates that music targeted to the audience and to the brand and offering has a potentially greater economic impact on the retailer.

We believe that on-line retailers, by offering syndicated music on their websites, will experience similar results to those of off-line retailers (i.e., increased revenues). Syndicated music that is carefully selected to match the on-line retailer's targeted audience and brand image will add more value to the retailer than random music or no music. Because the retailer will derive added value by providing syndicated music, we believe the syndicator – the provider of such music – will be able to capture a portion of this added value. Therefore, the royalty rates for the statutory licenses covering performances used on retail websites should command a premium.

5. Appendices

Appendix 1A: Webcaster Analysis

Appendix 1B: Notes for EVE® Analysis

Appendix 2: Purchase Incentive / Rate of Return Analysis

Appendix 3: Royalty Rate Conversion / Recommended Per Performance Rate

6. Bibliography

Appendix 1A: EVE Analysis

Internet-Only Webcaster	Point of Viability

NOTE: Numbers subject to rounding

Volume		
Unique listeners per month		3,000,000 [1]
Listening hours per month per user		4 [2]

MONTHLY REVENUES

Audio Cost Per Thousand Exposures (CPM)	**$**	**30** [3]
Audio spot load per hour (:30)		12 [4]
Potential number of impressions per month		144,000,000 [5]
Price per impression	$	0.030 [6]
Percent of ad inventory sold		60% [7]
Total revenue from audio ad sales	$	2,592,000
Banner (on Player) CPM	**$**	**10** [8]
Banner spot load per hour (1 banner every two minutes)		30 [9]
Potential # of impressions per month (discount by 75%)		90,000,000 [10]
Price per impression	$	0.01 [11]
Percent of ad inventory sold		25% [12]
Total revenue from banner ad sales	$	225,000
Sponsorship		
Sponsorship opportunties per month		8 [13]
Estimated revenue per sponsorship	$	30,000 [14]
Total revenue from sponsorship sales	$	240,000
E-commerce		
Unique listeners per month		3,000,000
Percent of users that engage in e-commerce		1.9% [15]
Average amount spent per transaction		$39.88 [16]
Commissions		7.5% [17]
Total revenue from e-commerce sales	$	170,503
Other		[18]
Positive Differentiation Value (Monthly Revenue)	**$**	**3,227,503**
Annualized Revenue	*$*	*38,730,039*

Appendix 1A: EVE Analysis

MONTHLY EXPENSES			
Encoding			
Total cost to outsource encoding	$	3,000	19
Bandwidth or Streaming			
Average speed of transmission, kilobits per second (kbps)		50	20
Seconds per hour		3,600	21
Listening Hours (unique listeners * listening hours per month)		12,000,000	22
kilobits (kb) per month streamed		2,160,000,000,000	23
Convert to megabytes (MB) per month streamed		270,000,000	24
Price per MB	$	0.0008	25
Cost of Bandwidth or Streaming	$	226,895	
Data Storage or Hosting	$	4,000	26
Web Hosting	$	16,000	27
Product Development/R&D/Programming	$	177,513	28
Sales	$	1,069,950	29
Marketing	$	258,200	30
General and Administrative	$	129,100	31
Other Licenses	$	112,963	32
Depreciation & Amortization	$	64,550	33
Negative Differentiation Value (Monthly Expenses)	**$**	**2,062,170**	
Annualized Expenses	*$*	*24,746,043*	
Economic Value $$ (Monthly Operating Income)	$	1,165,333	
Economic Value % of Revenues (Operating Margin)		36.11%	

Appendix 1B: Notes for EVE® Analysis

	VOLUME
1	Unique listeners per month means the number of individuals who stream music on the webcaster's website in one month. Each individual is only counted once, even if they stream music many times. Wall Street Journal, "The Internet Offers a Radio Station Life After Death," February 5, 2001: NetRadio already achieves 2.5 million unique users per month. Forrester, "Self-Serve Audio Evolution," May 2000, projects 99 million streaming audio users by 2005. Webnoize, "Internet Radio Realities," Spring 2001, projects that Internet radio audiences will grow to 103 million users as early as 2002. An industry source stated figures between 1 million and 5 million unique listeners as a point of viability. We believe that 3 million is a reasonable figure for this analysis, anticipating the ongoing consolidation of the industry, and adoption of streaming technology. This number of unique users would comprise 1/33 of Forrester's projected US listener base for streaming audio.
2	Listening hours per month per user is the aggregate time that each unique listener is streaming DMCA-compliant music on the website in a month. Jacobs Media, "Corporation for Public Broadcasting Competitive Scan," January 2001, cites Arbitron "Broadband Revolution," October 2, 2000: In broadband homes, people are currently listening to streaming audio for an average of 18 minutes per day (9 hours per month). Forrester "Self-Serve Audio Evolution," May 2000: Current average radio listening hours = 10.2 hours per week (times 4 = 40.8 hours per month); current average Internet radio listening hours = 1 hour per week (times 4 = 4 hours per month). Industry Standard, "Internet in Media Time," May 1, 2000: Average annual radio consumption in 2000 = 1,074 hours, or 89.5 hrs per month. Industry sources have stated that 4 hours per month is a reasonable figure for webcasters at the point of viability. We believe that 4 hours per month is a reasonably conservative figure, especially given increased adoption of streaming, and movement from broadcast radio listening to Internet radio.
	MONTHLY REVENUES
	AUDIO ADS Audio advertisements are one source of webcaster revenue. Previously, audio advertisements were heard before the music streams (i.e., "gateway ads"); however, new technologies now allow audio ad insertion into the music stream, providing more opportunities for audio advertising.
3	Audio cost per thousand exposures (CPM) is the price that advertisers pay the webcaster to reach 1,000 listeners with their audio advertisement. Hi-Wire CEO quoted in Wall Street Journal, February 5, 2001, "Internet Offers Radio Station Life after Death" said that advertisers are willing to pay $30-$60 CPM for a targeted audio commercial. Webnoize, "Internet Radio Realities," Spring 2001: $25-$40 CPM. Jupiter, "Luring Listeners as Worlds Collide," December 20, 2000: Various rate cards show CPMs in the range of $50-$120, $40-$85, $15-$35, $35-$42. Radio and Internet Newsletter, June 8, 2000, "The national rep firms are telling us that the basement (price) is an unwired (i.e., no geographical targeting) buy at a $35 CPM. What we're selling in our local markets is a $45-55 CPM. We've gotten buys up to a $100 CPM." Kagan Streaming Summit, March 2001: Gordon Bridge (SurferNetwork) stated that audio ads will sell for more than traditional radio. Traditional radio is $8-$10 CPM, audio ads today are selling in the $30-$60 CPM range. He said that prices should go up significantly with targeting over time, as advertisers improve the ability to refine the parameters of who is receiving the ads. We believe that this CPM rate will be higher than rates for radio stations, due to targeting and the interactive nature of the advertising. Industry sources have stated that $30 CPM is reasonable for the point of viability. We believe that $30 CPM is a reasonable figure.

Appendix 1B: Notes for EVE® Analysis

4	Audio spot load per hour is the number of audio advertisements that will potentially be transmitted in one hour of programming, assuming that each audio ad is 30 seconds long. We believe that Internet radio spot loads will approach those of broadcast radio. Jacob's Media, "Corporation for Public Broadcasting Competitive Scan," January, 2001 -- The "overwhelming majority of radio stations run at least 12 spots per hour, with many running more than 14" at present. Radio and Internet Newsletter, June 8, 2000, for webcasters, audio spot load per hour = 12 spots at present. Streaming Media, "Q&A With BroadcastAmerica," May 31, 2000 -- 12 spots per hour for average radio station, at present. Industry sources have stated figures between 10 and 12 spots per hour as reasonable. We believe that 12 audio spots per hour is a reasonable figure. NOTE that much webcasting will be Internet transmission of AM/FM broadcasts, where the current 12-14 ads per hour will be simply replaced with inserted ads.
5	Potential number of impressions per month is the calculation, (unique listeners per month * listening hours per month * audio spot load) = (3,000,000 * 4 * 12) = 144,000,000.
6	Price per impression is the calculation, (CPM divided by 1,000) = ($30 / 1,000) = $0.030.
7	Percent of ad inventory sold is the percentage of audio ad spots available (i.e., ad inventory) that has been sold to advertisers. Industry sources have stated figures between 40% and 70% for point of viability. We believe that 60% is a reasonable figure. As Internet radio demonstrates value as an ad property, and as targeting capabilities for advertising improve, we project that successful webcasters will be capable of selling more of their inventory than current webcasters.
	BANNER ADS ON PLAYER Banner ads are another source of revenue for webcasters. These are the traditional Internet visual ads. We are only considering the banner ads on the player, i.e., not on other parts of the website. If the webcaster had banner ads elsewhere on the site, those ads would generate additional revenue (i.e., increase the webcaster value).
8	Banner cost per thousand exposures (CPM) is the price that advertisers pay the webcaster to reach 1,000 listeners with their banner (i.e., visual) advertisement. The Standard, "Net Ads Keep on Ticking," September 4, 2000, cited $27 average CPM rates for banner ads on music/streaming media sites, at present. AdRelevance, "The State of OnLine Advertising," February 2001: Average rate card Q4 2000 for Music and Streaming Media websites = $25 CPM. Yahoo! Rate Cards, February 23, 2001, for categories including music and radio, CPMs = $36-$69 and $57-$72. Radio and Internet Newsletter, June 8, 2000, for webcasters, typical banner ads sell for about a $20 CPM, at present. DoubleClick Entertainment rate card = $25-$40 CPM, March 28, 2001. Industry sources have stated $10 CPM as reasonable for the point of viability. Ads in the past year have gone as high as $20-$30 CPM. Rates have since come down due to market shifts, but can be expected to go up in the future for the viable webcaster. We believe that $10 is a reasonable figure, reflecting a significant discount off today's published rate cards. (See also item 10 describing a discount on ad exposures).
9	Banner spot load per hour is the number of banner advertisements that will potentially be transmitted in one hour of programming. Industry sources stated spot loads between 15 (1 every 4 minutes) and 120 spots (1 every 30 seconds) for present day webcasters. We believe that a load of one banner every 2 minutes is a reasonable figure for a webcaster at viability, considering only one banner ad displayed on the player.

10	Potential number of impressions per month is the calculation, (unique listeners per month * listening hours per month * banner spot load * 25%) = (3,000,000 * 4 * 30 * 0.25) = 90,000,000. This number is discounted by 75% to account for the idea that in 5 years, some listeners will stream music from non-PC devices, some of which may not display banner advertising. An industry source stated that in 5 years, 75% of streaming will be via non-PC devices. NOTE: A webcaster will likely have banner ads in addition to those on the player, elsewhere on the site. While those ads will generate additional revenue attributable to the music (and additional positive differential value), the number of additional ads will be a function of the structure of the site. We have not attempted to quantify that additional revenue so as not to speculate on the number of additional pages that might be available from site to site.
11	Price per impression is the calculation, (CPM divided by 1,000) = ($10 / 1,000) = $0.010.
12	Percent of ad inventory sold is the percentage of banner ad spots available (i.e., ad inventory) that has been sold to advertisers. AdRelevance, "The State of OnLine Advertising," February 2001: Q4 2000 House advertising for Entertainment/Society websites = 30%, meaning 70% ad inventory was sold. An industry source has stated figures of 40% to 50% for point of viability. Another suggested limiting advertising to 2 spots per listener per hour. We believe that 25% inventory sold is reasonable for a viable webcaster.
	SPONSORSHIP Sponsorship is a source of webcaster revenue. An advertiser or organization may sponsor a program, event, a portion of the website, or e-mail campaign.
13	Sponsorship opportunities per month are the number of sponsorships allowable by the webcaster each month. Industry sources have stated figures between 4 and 8 for point of viability. We believe that 8 is a reasonable figure for a viable webcaster.
14	Estimated revenue per sponsorship is the price a sponsor must pay for the sponsorship opportunity. An industry source stated that the figure of $30,000 per sponsorship opportunity is reasonable for a webcaster at the point of viability.
	E-COMMERCE E-commerce is a source of webcaster revenue. E-commerce allows the user of the webcaster's site to make retail purchases. Depending on the business model, purchases might be made either directly from the webcaster's website, or through an affiliate agreement with a third-party retail site (e.g., Amazon.com). In this case, we assume the latter scenario, where the webcaster receives a commission on the sales.
15	Percent of users that engage in e-commerce is the percentage of listeners who will make a purchase. We conservatively include only listeners, not other visitors to the webcaster's site who don't stream. The Standard, "The Detail on E-Retail," May 1, 2000: "Net pure-plays find that 3.5% of unique visitors make a purchase." Audiobase, "Building a Sound Foundation for E-Commerce," September 22, 2000: Less than 3% of on-line shoppers ever become buyers. Wall Street Journal, "Clinching the Holiday E-Sale," October 9, 2000: 1.8% of retail website visits are converted to purchases. Industry sources have stated figures between 1.5% and 2% at point of viability. We believe that 1.9% is a reasonable figure, especially given webcasters' claims to promote music sales. This would represent a 5% per year increase over the 1.5% of listeners, to reflect a viable webcaster's improving its sales conversion rate.

16	Average amount spent per transaction is the average dollar value of each e-commerce transaction. Shop.Org Press Room, citing Boston Consulting Group data from February 26, 2001: "Online consumers in the least satisfied category spent $428 in the 12 months of 2000, while satisfied respondents spent $673 online, engaging in nearly 50 percent more transactions. Satisfied customers engaged in 9.4 transactions while the unsatisfied customers had an average of 6.5 transactions over the 12 months." $428 / 6.5 transactions = $65.85 average expenditure per transaction $673 / 9.4 transactions = $71.60 average expenditure per transaction BizRate.com: Average purchase amount of online purchases of books, music, DVD's and videos, May-Sept 2000 = $50-$68. We estimated a current average purchase of $25, increasing by 25% by 2005 to reflect the broadening of e-commerce products sold by webcasters, and improved branding. The average price per e-commerce transactions also assumes an additional increase of 5% per year to reflect inflation. Industry sources have stated that the resulting purchase price of approximately $40 is reasonable.
17	Commissions are paid by the third-party retail site to the webcaster. Commissions are typically a percentage of the e-commerce purchase price. Webnoize report, "Internet Radio Realities," Spring 2001: "Volume is the key, and a heavily trafficked webcasting hub could command an affiliation fee of 10-15% [of the purchase price], as compared to the 5-7% offered to smaller sites." Industry sources have stated figures between 7.5% and 10% as reasonable for a viable webcaster. We believe that 7.5% of the purchase price is a reasonable figure for a webcaster at the point of viability.
	OTHER REVENUE SOURCES
18	Our research indicates that many webcasters will have additional revenue sources that could be included in positive differentiation value. Examples include live streaming concerts, and revenues from the sale of programming technology to allow users to program DMCA-compliant playlists. We conservatively do not include these additional revenues because they are difficult to credibly quantify, and may not apply to the industry as a whole. However, we must call attention to their existence, as they do add to the economic value of the statutory license.
	MONTHLY EXPENSES
	ENCODING Encoding is a technical process that converts the sound recordings to a digital format for transmission over the Internet.
19	Total cost to outsource encoding is the cost the webcaster pays to a third-party to encode the music. We believe that outsourcing the encoding process to a third-party is becoming more common than the webcaster encoding in-house. This total represents, at the point of viability, a monthly license cost to access an already-encoded library from a service provider. Industry sources have stated that $3,000 per month for encoding costs is reasonable for the point of viability. NOTE that if a webcaster chooses to use the encoded music for purposes other than streaming DMCA compliant music, then the encoding cost is not an incremental cost to this business, and the economic value of the statutory license would be higher.
	BANDWIDTH OR STREAMING Streaming is the process of transmitting the sound recordings from the webcaster to the listener. Bandwidth is the volume of Internet "pipeline" used to transmit the sound recordings. Webcasters typically pay according to volume of music streamed.

20	Average speed of transmission is the speed at which the sound recordings are streamed to the listener. This is measured in kilobits per second (kbps). Wired.Com, "Shrinking Streams to Grow Bigger," November 23, 2000: Current bit rates range from 20 to 64 kilobits per second (kbps). Industry sources have stated figures from 50-56 kbps for the point of viability. We believe that 50 kbps is a reasonable figure. As codecs and associated technology improve, webcasters will be able to stream better quality music with smaller streams, yet there will still be some variability as listeners demand different levels of quality. This idea is further validated in the Live-365 "Understanding Internet Radio" discussion of multicasting, as well as Panel 1 of the Kagan Streaming Summit, March 2001.
21	Seconds per hour is the calculation, (seconds per minute * minutes per hour) = (60 * 60) = 3600.
22	Listening hours is the calculation, (unique listeners per month * listening hours per month) = (3,000,000 * 4) = 12,000,000.
23	Kilobits (kb) per month streamed is the calculation, (average speed of transmission (kbps) * seconds per hour * listening hours per month) = (50 * 3,600 * 12,000,000) = 2,160,000,000,000.
24	Megabytes (MB) per month streamed is the calculation, (kilobits per month streamed divided by 8 kilobits per kilobyte divided by 1,000 kilobytes per megabyte) = (2,160,000,000,000 / 8 / 1,000) = 270,000,000.
25	Price per megabyte (MB) is the cost the webcaster pays for bandwidth. Jupiter, "Online Music Radio: Luring Listeners as Worlds Collide," December 20, 2000, cites that streaming companies are typically charging $.005 per MB. The Standard, "Streaming Bleeds Cash," September 25, 2000: $.01 per MB. Streaming Media report, "The Cost of Streaming Services" 2000, cites that prices vary significantly. 100% of respondents streaming over 10 million MB per month were paying less than one penny per MB. Six rate cards for streaming over 10 million MB ranged from $.0075 per MB to $3 per MB. These rates are typically negotiable, i.e., webcasters will ask for discounts. Wired.Com, "Shrinking Streams to Grow Bigger," November 23, 2000, "Bandwidth is falling faster than Moore's Law. Bandwidth costs decrease by half about once every 12 months." Kagan Streaming Summit, March 2001, Jeff Morris, Panel 1: Codecs and compression algorithms are improving. Moore's Law states that "Every 18 months, processing power (of semiconductors) doubles while cost hold constant." This law has proven true through the years and will remain true for the foreseeable future. It is commonly believed that telecommunications bandwidth, computer storage, and other new technologies are subject to Moore's Law, whereby capacity doubles every 18 months (Southwest Missouri State University, Department of Management website). An effect of Moore's Law is that these technologies cost approximately half as much in this same timeframe (MIT Technology Review, May/June 2000). We believe that a webcaster at the point of viability will be able to negotiate the best prices for bandwidth, and therefore use $.005 per MB as a starting point. We then discount this over 5 years at 30% per year, to reflect the fact that bandwidth prices are reported to fall according to Moore's Law. An industry source has stated that this is a reasonable way to project declining costs of bandwidth.
	DATA STORAGE OR HOSTING
26	Data storage or hosting costs are for the infrastructure (i.e., technology and support) needed to store the sound recordings. This infrastructure can be owned by the webcaster, however, we believe outsourcing data storage or hosting to a third-party will be more common. Kagan Streaming Summit, March 2001, Jeff Morris, Panel 1: Codecs and compression algorithms are improving. "Moore's Law applies on storage." Like encoding, we believe that webcasters will pay for access to an already-stored library of music. Industry sources have stated that $4,000 per month is reasonable for a webcaster at the point of viability. We believe that $4,000 per month is a reasonable figure. NOTE that if a webcaster chooses to use the stored music for purposes other than streaming DMCA compliant music, then the storage cost is not entirely an incremental cost to this business, and the economic value of the statutory license would be higher.

	WEB HOSTING
27	Web hosting costs are for the infrastructure (technology and support) needed to manage the webcaster's website. An industry source has stated the figure of $8,000 per month for a smaller webcaster, and $16,000 per month for the point of viability. We believe that $16,000 is a reasonable figure. NOTE that if a webcaster chooses to use the website for purposes other than streaming DMCA compliant music, then the web hosting cost is not a completely incremental cost to this business, and the economic value of the statutory license would be higher.
	PRODUCT DEVELOPMENT/R&D/PROGRAMMING
28	This cost represents in-house technical costs, including personnel to manage information technology, as well as programmers of content, research, and development of new products such as players. An industry source has stated a figure of 5.5% of revenues is reasonable for a webcaster at viability. NOTE that if a webcaster chooses to use its technical resources for purposes beyond streaming DMCA compliant music, then this cost is not a completely incremental cost to this business, and the economic value of the statutory license would be higher.
	SALES
29	Commissions are paid by the webcaster to the advertising agencies, which represent the advertisers. Commissions are a percentage of the ad and sponsorship revenue generated. Radio and Internet Newsletter, February 16, 2001: 30-40% commission on ad revenue RIAA's negotiated agreements allow up to 30% commissions on ad revenue. Industry sources have stated figures of 35% for a viable webcaster. We believe that 35% of ad and sponsorship revenues is a reasonable figure for a webcaster at the point of viability.
	MARKETING
30	Marketing costs are the webcaster's expenses to promote their site and build their brand. Industry sources have stated figures between 8% and 10% of revenues for webcasters who have built their brand, depending on size. We believe that 8% is a reasonable figure for the point of viability, because over time a business will be more efficient in using its resources, and the expense will be smaller as a percentage of a large webcaster's revenues, though it grows in absolute dollars. NOTE that if a webcaster engages in businesses beyond streaming DMCA-compliant music, the marketing and other overhead costs would be allocated across multiple types of services. Therefore only a fraction of the cost would be incremental to this business, and the economic value of the statutory license would be higher.
	GENERAL AND ADMINISTRATIVE (G&A)
31	G&A costs are general operating expenses and infrastructure costs typically associated with operating a business enterprise. These may include, but are not limited to, executive and administrative salaries, utilities, real estate, office supplies and incidental expenses. Some salaries in this model are captured in Product Development/R&D/Programming, Encoding, and Sales. An industry source stated a figure of 4% of revenues as reasonable for the point of viability. NOTE that if a webcaster engages in businesses beyond streaming DMCA-compliant music, or is owned by another entity, the G&A and other overhead costs would be allocated across multiple types of services. Therefore only a fraction of the cost would be incremental to this business, and the economic value of the statutory license would be higher.
	OTHER LICENSES
32	BMI/ASCAP licenses for musical work rights. We use 3.5% of revenues.

Appendix 1B: Notes for EVE® Analysis

	DEPRECIATION & AMORTIZATION
33	Depreciation is the decline in value of property caused by wear or obsolescence and is usually measured by a set formula, which reflects these elements over a given period of useful life. Amortization is the allocation (and charge to expense) of the cost or other basis of tangible and intangible assets over its estimated useful life. We estimate that for a small webcaster today, D&A may be estimated at 7% of revenues. This percentage would decrease by 10% annually over 5 years, as a webcaster would become more efficient in their use of fixed assets. For a larger player (who is generating more revenues), we estimate costs at half of this figure. This results in an estimate of 2% of revenues for a webcaster at the point of viability. An industry source has stated that 2% of revenues is reasonable for a viable webcaster. NOTE that if a webcaster engages in businesses beyond streaming DMCA-compliant music, the depreciation and other overhead costs would be allocated across multiple types of services. Therefore only a fraction of the cost would be incremental to this business, and the economic value of the statutory license would be higher.

Appendix 2: Purchase Incentive / Rate of Return Analysis

Chart A - Inputs to ROR Analysis

FROM Appendix 1A Internet-only Economic Value Analysis		
Webcaster Annualized Revenues at point of viability (Year 5)	$	38,730,039
Economic Value, or Operating Margin at point of viability, BEFORE PAYING compulsory license fees		36.11%
FROM Chart B, Average Revenues and Expenses for Year 0		
Webcaster Average **Revenues** Year 0	$	266,428
Webcaster Average **Expenses** Year 0	$	2,298,592

Chart B - Sample Current-State Webcasters

	RIAA Licensee	NetRadio 1998	Averages
Revenue	$ 277,856	$ 255,000	$ 266,428
Op Expense	$ 390,184	$ 4,207,000	$ 2,298,592
Op Income	$ (112,328)	$ (3,952,000)	$ (2,032,164)

NOTE: Numbers subject to rounding

Chart C -- Solve for Operating Margin in Year 5, for 20% ROR

Input Acceptable Rate of Return			20%	
Solve for Operating Margin Required to Generate Return			8.43%	
* Shaded row indicates point of viability				
Year	**Total Expenses**	**Total Revenue**	**Op Margin**	**Op Gain/Loss**
0	2,298,592	266,428	-762.74%	(2,032,164)
1	3,973,073	721,230	-450.87%	(3,251,844)
2	6,867,383	1,952,393	-251.74%	(4,914,990)
3	11,870,142	5,285,192	-124.59%	(6,584,950)
4	20,517,318	14,307,190	-43.41%	(6,210,128)
5	35,463,798	38,730,039	8.43%	3,266,241
6	40,196,364	44,539,545	9.75%	4,343,181
7	45,594,789	51,220,476	10.98%	5,625,688
8	51,755,650	58,903,548	12.13%	7,147,898
9	58,789,764	67,739,080	13.21%	8,949,316
10+	**Present Value of Expected Future Earnings**		**13.21%**	**44,746,580**
			IRR	**20%**

Chart D -- Solve for Operating Margin in Year 5, for 30% ROR

Input Acceptable Rate of Return			30%	
Solve for Operating Margin Required to Generate Return			17.05%	
* Shaded row indicates point of viability				
Year	**Total Expenses**	**Total Revenue**	**Op Margin**	**Op Gain/Loss**
0	2,298,592	266,428	-762.74%	(2,032,164)
1	3,895,345	721,230	-440.10%	(3,174,115)
2	6,601,306	1,952,393	-238.11%	(4,648,913)
3	11,187,004	5,285,192	-111.67%	(5,901,813)
4	18,958,229	14,307,190	-32.51%	(4,651,039)
5	32,127,854	38,730,039	17.05%	6,602,184
6	36,360,028	44,539,545	18.36%	8,179,516
7	41,183,003	51,220,476	19.60%	10,037,474
8	46,682,096	58,903,548	20.75%	12,221,451
9	52,955,177	67,739,080	21.82%	14,783,903
10+	**Present Value of Expected Future Earnings**		**21.82%**	**49,279,676**
			IRR	**30%**

NOTE: Numbers subject to rounding

Appendix 2: Purchase Incentive / Rate of Return Analysis

METHODOLOGY AND ASSUMPTIONS UNDERLYING ROR ANALYSIS

We have established that a stand-alone webcaster operating at the point of viability can earn a 36.11% operating margin, BEFORE paying for the statutory license. This is the economic value of the statutory license. We must now determine what portion of that value can be captured by the copyright holders, i.e. what is an appropriate royalty to charge the webcaster.

As stated in the report, an appropriate royalty rate is one that would allow the webcaster to generate a reasonable rate of return on its investment in the business of webcasting. A webcaster's "return" is defined as the amount of money the webcaster will earn from being in this business, above and beyond what is required to cover operating losses in the early years as well as ongoing operating expenses. "Return" is most often expressed as an annual percentage rate, or "rate of return" (ROR). The ROR equates to an annual "interest rate" the webcaster wishes to earn on a particular investment (here, the investment is the amount of money needed to cover operating losses) for every year of the investment.

Although ROR is normally expressed as a constant annual percentage rate, the actual realized rate of return is seldom constant from year to year. In many cases, the rate grows over time. In this example, the rates of return are higher in the later, more profitable years. Standard practice in evaluating ROR is therefore to compute the annualized (constant from year to year) rate of return that is equivalent to the fluctuating rates actually realized. We consider an annualized rate of return of 20%-30% to be reasonable, as discussed in the text.

Given that, without paying for the statutory license, the webcaster can earn a 36.11% operating margin, we must now determine what operating margin the webcaster would NEED to earn in order to generate the target rate of return. As discussed in the text, that operating margin is the "purchase inducement" to the webcaster. The DIFFERENCE between these two operating margins is the portion of the value that should be captured by the copyright holders, and therefore charged to the webcaster as the royalty (See also SPG Report Figure 2). This analysis solves for the necessary operating margin, as follows:

1. MODEL THE WEBCASTER'S GROWTH

In order to analyze rates of return, we need to model the webcaster over its lifetime. Here we model three phases of growth: Year 0 (representing webcasters prior to this proceeding), to the point of viability in Year 5; Years 6 to 9, where the webcaster is still growing, but at a much slower rate; and a steady state after Year 9, where the webcaster is no longer growing. We model the annual revenues

and expenses, and calculate the resulting annual operating margins ((revenues-expenses)/revenues) and operating gain or loss (revenues-expenses), for each of the three phases, as shown in Charts C and D.

Year 0-5 -- As shown in Chart B, we use an average of revenues and operating expenses of NetRadio in year 1998, and a smaller RIAA licensee in year 2000. We choose 1998 for NetRadio to represent more typical webcasters today, who have not yet reached NetRadio's present size. Since no one can know exactly how revenues and expenses will grow for any particular webcaster until the point of viability, we extrapolate the growth of revenues and expenses between the two points that we have established at Years 0 and 5, by growing the revenues and expenses at their respective average annual growth rates (resulting in the same percent rate of growth every year). This is a conservative method, resulting in lower growth (in terms of actual dollars) in early years. This is the reason that the model does not show profitability for the webcaster until after Year 4. NOTE: The figures for Total Expenses in Year 5 are different from those in the EVE® analysis (Appendix 1A), because here they reflect the operating margin which this model computes, as described in Step 2 below.

Year 6-9 -- Here we assume that both the industry in general and the webcaster will continue to grow. Since the industry will start to stabilize, and will have gone through significant consolidation by this point, we use a more conservative growth rate here than in the earlier years.

Year 10 and Beyond -- To maintain a conservative perspective on the model, we assume that the business will be in a steady state in Year 10 and beyond-- It will not grow, but will continue to generate value (earnings), which must be accounted for. We account for the ongoing value of these earnings by taking their present value (earnings in Year 9, divided by required rate of return). If the webcasting business were to be sold at any point in time, the sale value would also take these future earnings into consideration.

2. SOLVE FOR THE NECESSARY OPERATING MARGIN AT POINT OF VIABILITY (YEAR 5)

Once the growth in revenues and expenses over the lifetime of the webcaster is modeled, it is possible to solve for the operating margin at the point of viability which the webcaster must earn, to be in a position to cover all operating losses AND generate the target annual rate of return (20%-30%) over its lifetime. Chart C shows the results for a 20% rate of return, and Chart D shows the results for a 30% rate of return. We can see that the "IRR" (Internal Rate of Return) calculation of the column of operating gains and losses confirms that the resulting operating gains and losses provide these returns to the webcaster. IRR is defined as the "interest rate" received for an investment

consisting of payments (negative values) and income (positive values) that occur at regular periods (here, years).

Note that revenues are identical in both Charts C and D, but expenses are different (after Year 0). This is because the different rates of return will require the webcaster to earn different operating margins-- a higher rate of return will demand a higher operating margin (more profitability), and a lower rate of return will need less of a margin.

The difference between the operating margin representing the economic value (36.11%) and the necessary operating margin to generate the ROR (8.43%-17.05%) is the portion of the economic value that can be captured by the copyright holders. This is converted into a per-performance royalty rate in Appendix 3.

Appendix 3: Royalty Rate Conversion / Recommended Per Performance Rate

NOTE: Numbers subject to rounding

	FROM Appendix 1, Internet-only Economic Value Analysis	
A	Economic value (Operating Margin) at point of viability, before paying compulsory license fees	36.11%
B	Monthly webcaster revenues at point of viability	$3,227,503
C	Listening hours per month	12,000,000
D	Performances per hour	12
E	Economic value per performance	$ 0.0081

	FROM Appendix 2, Rate-of-Return Analysis		
F	Acceptable rate of return	**20%**	**30%**
G	Operating margin required to generate return (purchase inducement)	8.43%	17.05%

	Royalty Rate Conversion		
H	Value to be captured by copyright holders (A - G)	27.68%	19.06%
I	Monthly royalty $ (H x B)	$893,373	$615,162
J	Performances per month (C x D)	144,000,000	144,000,000
K	Per Performance Royalty Rate (I / J)	$ 0.0062	$ 0.0043

Exhibit 4

RESTRICTED – Subject to Protective Order in Docket No. 2009-1
CRB Webcasting III

Exhibit 5

RESTRICTED – Subject to Protective Order in Docket No. 2009-1
CRB Webcasting III

Exhibit 6

Non-Interactive Royalty Rate Calculation
Based on 95% Confidence Interval of Pelcovits' Interactivity Coefficient

Interactivity Coefficient [1]	Standard Error [1]	t Distribution Critical Value [2]	95% Confidence Interval Endpoints		Interactivity Adjustment [3]		Interactive Fee Per-Play [4]	Per-Play Adjustment [4]	Non-Interactive Royalty Rate	
			Low End	High End	Low End	High End			Low End	High End
$8.52	2.00	2.365	$3.79	$13.25	0.715	0.004	$0.02194	0.5101	$0.008	$0.00004

[1] Pelcovits p. 27.

[2] Wooldridge, Introductory Econometrics, 4th Edition, p.825.

[3] The interactivity adjustments are calculated as follows: 1) .004 = (13.3-13.25)/13.3; and 2) 0.715 = (13.3 - 3.79)/13.3.

[4] Pelcovits p. 33.

Before the
COPYRIGHT ROYALTY BOARD
LIBRARY OF CONGRESS
Washington, D.C.

In the Matter of	)	
	)	Docket No. 2009-1, CRB Webcasting III
DIGITAL PERFORMANCE RIGHT IN SOUND RECORDINGS AND EPHEMERAL RECORDINGS	)	

REBUTTAL TESTIMONY OF ALEXANDER "SANDY" SMALLENS

I. BACKGROUND & QUALIFICATIONS

1. My name is Alexander "Sandy" Smallens. I am the Founder and Managing Director of Audiation, Inc., a digital media consultancy which provides leadership, strategy and business development for start-ups and multi-national media companies, including Oddcast, My Damn Channel, AdBlade, TuneGenie, Vibe Media and MyNet. Much of my focus with Audiation is selling digital solutions to brands and agencies, as well as developing and selling sponsorships for new digital radio channels. As a seventeen-year digital media executive,[1] I have had operational responsibility for divisions in the following industries:

a) The Record Industry: I was the founder of Atlantic Records' multimedia department in 1995, one of the first fully-staffed such departments in the industry, which debuted the first full-length online streams of major artists such as Tori Amos. I was employed at Atlantic Records from 1993-1996.

[1] A copy of my curriculum vitae is attached as Exhibit 1.

b) Online Music Content: As a Senior Vice President of online music website SonicNet, and subsequently at MTVi (after their acquisition of SonicNet) in the last 1990s, I launched and oversaw the industry's first-ever audio-visual streaming radio product, Flash Radio, and oversaw the first-ever music video on demand site, Streamland. Later, as Executive Vice President of GetMusic (1999-2001), a joint venture of BMG Entertainment and the Universal Music Group which was eventually acquired by Vivendi and named Vivendi Universal Net USA, I created and oversaw Videolab, the first site to enable users to remix popular music videos, as well as GetMusic Karaoke, the first online karaoke application to feature major recording artists.

c) Broadcast Radio: In my capacity as Vice President for Interactive Sales & Marketing at CBS Radio (2005-2006), I was the corporate executive responsible for sales of all CBS Radio digital assets. Then, as Senior Vice President for the digital division at Entercom Communications (2006-2009), I had oversight of the entire digital platform, including the creation, operation and monetization of the company's streams, websites, podcasts and mobile products. At both CBS and Entercom, I engineered digital sales strategy, oversaw pricing and collateral, trained local sales staff and personally pitched multi-platform programs to hundreds of agencies and brands.

d) Digital Advertising: As Chief Operating Officer of Oddcast (2002-2004), a viral marketing agency and technology company, I sold complex branded entertainment solutions to advertising agencies and brands. I continue to work closely with the company.

2. At CBS, in particular, I was responsible for creating and selling digital asset sponsorship packages – including everything from station websites, streams, HD2 channels and podcasts – to companies such as DaimlerChrysler, Vonage, Verizon, AT&T, Quiznos, Monster.com, Motorola and many others. I also oversaw CBS's relationship with advertising networks like Yahoo! and worked closely to train ad sales teams in many of the company's markets to ensure fluency in online ad sales.

3. At Entercom, I had profit and loss (P&L) responsibility for the company's digital department, and had direct and dotted line responsibility for over 60 staff members, including a corporate operations team and webmasters and digital sales managers across the country. My team was responsible for all policies, decisions, deals, third-party vendor relationships and day-to-day operations of Entercom's digital assets, as well as all sales activities and ad operations. I reported to the CEO and was a member of Entercom's Operating Committee, a small team of senior executives charged with setting strategic priorities and policies for the company.

4. I have spoken at numerous digital conferences, including Radio Ink's Convergence, AdTech, Digital Hollywood, Streaming Media East, and several others. I was also involved in the development, testing and launch of TargetSpot, an online audio advertising network, in my capacities at both Oddcast and CBS Radio. Under my tenure, Entercom became the second major radio group to sign a partnership deal with TargetSpot, and I directly oversaw all aspects of that relationship.

5. I have been a songwriter and musician since high school, and from 1987 through 1994, I composed and performed with Too Much Joy, a Giant/Warner Brothers recording artist. Too Much Joy enjoyed Top 15 success on modern rock radio and toured nationally, performing with major acts such as The Go-Go's and The Flaming Lips.

6. I graduated from Yale University in 1987 with a B.A. in Political Philosophy. As a student at Yale, I was Editor-in-Chief of the campus' music magazine, *Nadine,* and concurrently interned at *Spin Magazine*, where I authored several articles.

7. The following testimony is based on my seventeen years of experience in the digital media industry, including five years in senior positions related to the digital space at top-tier terrestrial broadcasters; ongoing business development and sales responsibilities in the digital advertising space; extensive responsibilities at Atlantic Records; and my years as a recording artist.

II. OVERVIEW OF TESTIMONY

8. My testimony will rebut SoundExchange's rosy assessment of statutory webcasting that was presented at the direct hearing. Contrary to statements made in SoundExchange's direct case – and specifically by Dr. Pelcovits – statutory webcasting services are facing substantial economic challenges that point to a less-than-robust market, especially under the current royalty scheme. My testimony discusses the unique challenges that statutory webcasters face in attempting to maximize revenues for their product.

9. My testimony primarily addresses the following issues:

a) The growth of listenership in the statutory webcasting industry does not necessarily create a proportional growth in revenues. In fact, the glut of advertising inventory created by increased audience sizes exerts downward pressure on the revenue potential of statutory webcasters. Moreover, surplus advertising inventory is exacerbated by a unique set of challenges.

b) The marketplace for ad-supported music services is quite challenging, as witnessed by the failure and/or fire-sale of various entities in the space. For example,

after Last.FM's sale to CBS Interactive, Last.fm has not yet achieved profitability, and has in fact scaled-back its ad-supported offerings.

c) Subscribers account for a small and dwindling amount of statutory webcasting listening. The vast majority of statutory webcasting – unlike on-demand interactive services – is based on ad-supported, *non-subscription* listening.

d) Pandora, the most successful "pure play" webcasting company in terms of audience size and revenue, would have to spend almost every cent of its 2009 revenues on the sound recording royalty if it were subject to the full statutory rate for 2009 that was determined by the Copyright Royalty Board in the Webcasting II proceeding. Therefore, a royalty rate that is *higher* than (or even close to) the current rates – as SoundExchange has proposed in this proceeding – would not represent what a willing buyer would agree to.

e) Statutory webcasters have inherent economic disadvantages compared with the National Association of Broadcaster ("NAB") and Sirius XM simulcasters with respect to operating, marketing and sales costs as well as revenue generation.

f) Statutory webcasting provides promotional benefits, increases album/download sales, and provides much-needed exposure to copyright holders.

III. DR. PELCOVITS' ASSESSMENT OF THE STATUTORY WEBCASTING MARKET IS FUNDAMENTALLY FLAWED

10. In Section 4 of his written testimony, entitled "The Statutory Webcasting Market," Dr. Pelcovits provided a lofty assessment of the statutory webcasting industry as "the backdrop for [his] analysis."[2] He relies upon various secondary and tertiary sources for his

[2] SoundExchange Trial Ex. 2 (Amended & Corrected Written Direct Testimony of Dr. Michael Pelcovits ("Pelcovits ACWDT")), at 6-14.

premise of a "robust and evolving market for webcasting."[3] He makes this analysis without having spoken to any executives at any webcasting companies.[4] Instead, he cites growth in reported performances and listenership based on usage reports from SoundExchange, a report by Arbitron/Edison Research, as well as an examination of two recent market entrants, Last.fm and Slacker, which purportedly have been able "to succeed in the market."[5] In addition, Dr. Pelcovits points to the estimated growth of the overall advertising market for Internet radio as evidence of a "robust" market for webcasting.

A. Webcasting Listenership Has Flattened Over The Last Year

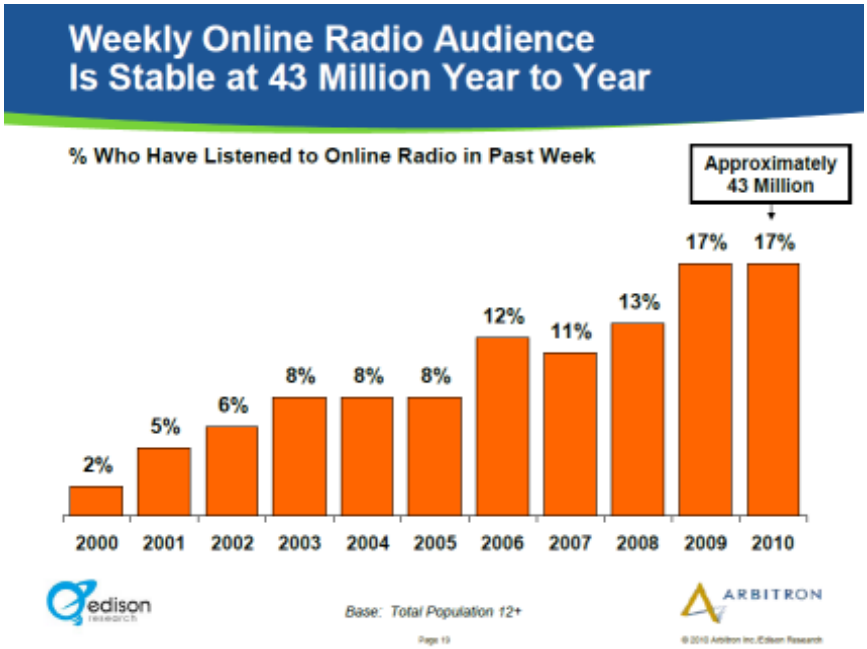
11. Dr. Pelcovits' assessment of the webcasting market is flawed in numerous ways. His finding that "the webcasting industry continues to grow" refers primarily to listenership, and does not take into account the difficulties in monetizing this growth. One of the main sources to support his growth assertion, the 2008 and 2009 "Infinite Dial" reports by Arbitron and Edison Media Research, combine both news/talk/sports and music formats, and does not provide a specific breakout. In my experience, for many terrestrial simulcasters, non-music formats – which do not have the same royalty obligations of Internet music services – dominate overall online listening and drive listenership growth. Therefore, Dr. Pelcovits' failure to take into consideration the allocation of listenership attributable to news, talk and sports formats, with respect to the report he cites, is a considerable flaw. In addition, as Internet penetration has leveled off, so too has online radio listenership. Since Dr. Pelcovits' testimony, the April 2010 Arbitron/Edison "Infinite Dial" study shows that listenership growth flattened from 2009-2010, as shown in the table below. Therefore, future growth of Internet radio listenership is uncertain.

[3] SoundExchange Trial Ex. 2 (Pelcovits ACWDT), at 11.

[4] Direct Hearing Tr., April 19, 2010, at 172:3-172:6.

[5] SoundExchange Trial Ex. 2 (Pelcovits ACWDT), at 10.

Table 1



B. Dr. Pelcovits Ignores Economic Realities Of The Webcasting Marketplace

i. Consolidation Of Listenership

12. Before addressing Dr. Pelcovits' disregard for industry economics, it is worthwhile to briefly examine the consolidation of listenership among Pandora and simulcasters (terrestrial and satellite). Specifically, the aggregate statutory webcasting market demonstrates that an increase in aggregate tuning hours and/or aggregate revenue of the entire industry is, in fact, heavily skewed by a few companies. According to Sound Exchange's 2009 usage reports, the top four entities in terms of aggregate performances are: Pandora ([redacted]% market share by volume); CBS Radio and Clear Channel ([redacted]% market share by volume); and satellite radio companies Sirius-XM ([redacted]% market share by volume). Combined, these four entities account for over 80% of 2009's aggregate yearly performances reported to SoundExchange.[6] The statutory webcasting market was not nearly as consolidated just a few years earlier, during which

[6] Live365 Trial Ex. 14 (SXW3_Native_0015 (RESTRICTED)), at 8.

time the top four entities represented only 50.58% and 53.82% of the aggregate performances in 2006 and 2007, respectively.[7] In his direct statement, Dr. Pelcovits did not break down the revenue growth, specifically for ad revenues, that are attributable to each company.

ii. Audience Growth Does Not Equate To Increased Revenues

13. An obvious point neglected by Dr. Pelcovits is that growth in webcasting listenership does not, in and of itself, translate to financial success or even viability – especially with the risk of increasing royalty rates. First, the overwhelming majority of statutory listening is ad-based, hence heightening the importance of advertising revenues. Second, every single song streamed triggers additional costs; however, ad-supported webcasters cannot recover these costs in the same per-song manner. Therefore, unless CPM (i.e., cost per thousand impressions) and inventory sell-out rates (i.e., the percentage of the total advertising impressions sold) keep pace with the growth in listenership, statutory webcasters – which are already saddled with increasing hosting, bandwidth and royalty costs due to this growth – are indeed penalized for the success of their increased listenership. However, given persistent industry trends, CPMs are subject to significant downward pressures. Consequently, the inverse relationship between costs associated with listenership growth and CPM revenues will likely continue. These findings are all consistent with my own observations in the industry.

iii. Dr. Pelcovits Disregards The Decline In Advertising Rates And Its Impact On The Economic Health Of The Statutory Webcasting Industry

14. Dr. Pelcovits' analysis of the statutory webcasting industry suffers from other deficiencies. Specifically, he failed to consider CPM rates, inventory sell-outs, and the impact of each factor on the statutory webcasting market. Again, these are important factors because the majority of statutory webcasting is ad-based listening.

[7] Live365 Trial Ex. 14 (SXW3_Native_0015 (RESTRICTED)), at 2, 4.

15. In addition to audience size, the most relevant factors are advertising *rates* (in the form of CPMs) – not aggregate advertising *revenues* – and inventory sell-out rates. In my experience, these metrics determine the revenue potential for ad-supported services (and, implicitly, the royalty rate they could afford to pay). Statutory webcasters can assess their revenue potential in a variety of ways. One manner is to assess the total impressions served over the course of a given time period and factor in average CPMs and sell-out percentage. Impressions can be determined by multiplying total monthly listening sessions by average spots served per listening session. In other words, if my station's listeners generally stay connected for 90 minutes (i.e., that is the station's Average Time Spent Listening, or TSL), and I serve six spots per hour, I know that each listening session generates an average of nine ad impressions. Put into practice, if I know my listenership generates a total of one million ad impressions over a month, and I generally sell 50% of that inventory at a $3 CPM, then I know the current revenue potential of this station is $1,500/month (500,000 impressions sold at a $3 CPM). No such analysis, which could have illustrated webcasters' ad revenue capabilities, was provided by Dr. Pelcovits.

16. In my experience with terrestrial broadcasters, CPMs for online audio ads have generally been stagnating or declining – especially for inventory that is sold via multi-market deals or ad networks (such as TargetSpot). Multiple sources confirm this stagnation and/or reduction in average statutory webcasting industry CPMs. Dr. Pelcovits, for example, acknowledged that there is no evidence of CPMs increasing:

> *Q. Sitting here today, you cannot say that CPMs have been rising, can you?*
>
> *A. Are you talking about CPM in terrestrial broadcasting or in webcasting?*
>
> *Q. Well, let's start with the webcasting market.*

A. I have not seen evidence of CPM increasing.[8]

17. Further, Live365's General Manager of Media, Johnie Floater, cites internal data that reveal a decline in CPMs since 2006 for streaming audio ads as well as CPMs for ad banners and video gateway ads (short, video-based ads that play automatically when a user clicks to listen to a stream).[9] And in his testimony, BIA/Kelsey Vice President Mark Fratrik, PhD, confirms that CPMs for audio ads have fallen steadily since 2005, citing figures from AccuStream iMedia Research released in 2009.[10] Even major streaming media destinations such as MySpace and YouTube are plagued by low CPMs and "low-value," excess ad inventory "that can only command weak CPMs, and they're not growing its value as quickly as content costs are growing."[11] All of these findings are consistent with my own observations.

C. Statutory Webcasters' Necessary Reliance On Ad Networks Results In Lower Yield And Higher Cost Of Sale

18. Non-interactive webcasters face a specific challenge in monetizing their audio ad inventory. Since there is theoretically no limit on a statutory webcasters' ad inventory – as opposed to the finite inventory of terrestrial radio stations, which can drive demand and command higher CPMs (as I observed during my experience at two of the largest terrestrial radio companies in the U.S.) – adding listeners does not necessarily drive more value creation. As Mark Mulligan of Forrester Research concludes, "many ad-supported content destinations are

[8] Direct Hearing Tr., April 19, 2010, at 177:15-20.

[9] Live365 Trial Ex. 29 (Corrected Written Direct Testimony of Johnie Floater, April 25, 2010 ("Floater CWDT")), at 5.

[10] Live365 Trial Ex. 30 (Corrected & Amended Written Direct Testimony of Mark Fratrik, April 26, 2010), Exhibit 3 at Section Three

[11] Mark Mulligan, "Paying for Success: When Audiences Grow More Quickly Than Ad Revenue." Forrester Research, April 17, 2009 (SXW3_00018073 – 00018079), at 3. *See* Exhibit 2.

not growing ad revenue effectiveness as quickly as their audiences are growing in size and level of engagement."[12]

19. Audience growth without complimentary growth in sell-out rate creates a "glut" of unsold inventory. To address this, non-interactive webcasters who do not have sufficiently-sized local audiences that can be targeted and who lack the robust, specially-trained sales forces of the NAB simulcasting entities, must rely on ad networks. Ad networks aggregate unsold advertising inventory from a variety of online entities and make it available to marketers. This inventory is commonly referred to as "remnant" – left-over advertising spots which generate a small number of ad impressions. By collecting this disparate inventory from multiple websites, ad networks hope to amass enough impressions to be able to sell it. Marketers generally expect to pay lower CPMs for ad network inventory because it is an amalgamation of remnant impressions. In my experience at both CBS Radio and Entercom, streaming ad network inventory was generally sold at a sub-$5 CPM – which my experience indicates to be the industry standard. By contrast, based on my own observations, NAB simulcasters' locally-sold streaming audio ads and video gateway ads generally garner double-digit CPMs.

20. In addition, ad networks charge aggressive commissions to sell this low-priced inventory. These commissions are generally higher than the commissions that would be paid to an in-house salesperson for selling the same inventory. So webcasters that are reliant on ad networks yield lower revenues from their ad inventory and realize a much smaller percentage of revenue for every dollar made. For this reason, media companies generally consider ad networks to be a last resort, backfill for the less desirable inventory that their sales team cannot monetize. In fact, in December 2009, CBS Interactive – whose online properties contain highly trafficked

[12] *See id.* at 2.

content (including CBS.com, CNET, Gamespot and TV.com) – declared they would almost completely eliminate their reliance on third-party ad networks.[13]

21. Further, there are not enough streaming media advertisers making big enough buys to fill even this lower-priced inventory. As Johnie Floater has testified, "advertising orders consistently do not fill all of Live365's advertising inventory; therefore, increasing the number of ad spots her hour would not generate more revenues since Live365 already cannot fill all of its commercial availabilities."[14] I am not surprised by this comment. In my capacity at both CBS Radio and Entercom, most major online ad buys happened in the context of cross-platform deals (including on-air and online inventory). Marketers generally earmarked a small percentage (5-10%) of their total spend to online, and did so at low CPMs. Frequently, the online portion of the buy would be the first thing to go if their budgets tightened up. This problem is exacerbated by the fact that many streaming network buys are "dayparted" – limited to airing during specific hours of the broadcast day, which means that weekends and overnight hours are vastly undersold. The shortfall of paid ads results in webcasters over-delivering for their existing advertisers or rotating "house" or promotional spots through the ad inventory, prompting a deterioration of the quality of the listening experience for the user. This can lower Average Time Spent Listening (TSL) and, therefore, reduce the number of ad impressions served per listening session, further reducing revenue generation. At the same time, the webcaster is incurring per performance costs for the listenership during the undersold non-daypart hours.

22. There is a variety of reasons for this shortfall in advertising sales. Streaming audio advertising is still relatively new to marketers, and commands a low single-digit

[13] Michael Learmonth, "CBS Interactive Dumps Ad Networks," *AdvertisingAge*, Dec. 14, 2009, available at http://adage.com/digital/article?article_id=141054. *See* Exhibit 3.

[14] Live365 Trial Ex. 29 (Floater CWDT), at 4-5.

percentage of overall broadcast radio revenues. In addition, producing quality streaming radio ads requires a different expertise than producing, say, a compelling banner ad, and many marketers are reluctant to delve into this area. In many cases, webcasters display synchronized ad banners when a streaming audio spot plays, but it is difficult to determine if the listener is looking at their streaming web player when these banners display or has either minimized the player or buried it beneath other browser windows. It has been my experience that synchronized banner ads for streaming audio spots have historically generated low click-through rates for this reason, another discouraging factor in the eyes of media buyers.[15]

23. Also, as I explain below in my discussion of the differences between pure Internet radio services and broadcast simulcasters, Internet radio companies – which do not have mass audiences concentrated in a particular geographical market – have to rely on national advertisers as a source of revenue. These national advertisers are few, and have many other established outlets for their advertising (e.g., radio, television and cable networks; print, etc.) that offer larger audiences than Internet radio. Thus, it is not easy to cause these advertisers to change their practices to dedicate money to Internet radio. For these reasons, plus simply the amount of inventory that is available in the marketplace, webcasters generally have low CPMs and low sell-out rates that have not kept pace with their audience growth.

[15] Another factor leading to a misplaced view of the robustness in the online radio industry is Dr. Pelcovits' apparent reliance on inconsistent ad spending numbers, which seem to suggest a *decrease* in ad spending through 2011. On page 11of his Amended & Corrected Written Direct Testimony (SoundExchange Trial Ex. 2), he cites a $101 million figure in digital advertising spending for the radio industry *for the first quarter of 2009*. This suggests that digital advertising spending for the radio industry would be over $400 for the entire year in 2009. In the next sentence, he cites a different analysis that projects $350 million *for the entire year in 2011*. Note that the $350 million figure originally came from a report prepared by ZenithOptimedia, which revised its projections downward two times, and is now down to $286 million for its 2011 estimate.

D. Far From Dr. Pelcovits' "Robust And Evolving Market," The Ad-Supported Music Space Is Withering Under The Weight Of Royalty Payments To Record Labels; Last.fm Is Under-Performing

24. The Internet music space is littered with examples of failed and shuttered ad-supported music services (e.g., SpiralFrog, Ruckus Network) as well as once-promising music start-ups forced to sell themselves for a fraction of their previous value. imeem "raised above $50 million in funding over the last two years…with the valuation north of $200 million."[16] The company ended up selling to MySpace for "$1MM in cash" in December 2009.[17] Prior to its sale, the service had been "reportedly running out of money, especially because of how much it has to pay for music licensing deals it has with record labels."[18] Lala Media, Inc. ("Lala"), another popular music service, was recently acquired and then shuttered by Apple as of May 31, 2010.[19] Further, two of the largest companies subject to statutory rates and terms of Webcasting II – i.e., Yahoo! LAUNCHcast and AOL Radio – exited the webcasting business shortly after the Webcasting II determination by partnering with CBS Radio, who "powers" Yahoo! and AOL-branded offerings and provides all content licensing, programming and royalty payments.

[16] Rafat Ali, "Music Social Network Imeem In Play; Hires Bank; Laying Off 25 Percent," *PaidContent*, Oct. 22, 2008, available at http://paidcontent.org/article/419-music-social-network-imeem-in-play-does-25-percent-layoffs/. *See* Exhibit 4.

[17] Michael Arrington, "Ok, Now It's Done. MySpace Music Completes Acquisition of iMeem," *TechCrunch*, Dec. 8, 2009, available at http://techcrunch.com/2009/12/08/imeem-myspace-music-completes-acquisition/. *See* Exhibit 5.

[18] Eric Eldon, "Music startup imeem making money, not dying unless the labels kill it," *Venture Beat*, March 26, 2009, available at http://venturebeat.com/2009/03/26/music-startup-imeem-making-money-not-dying-unless-the-labels-kill-it/. *See* Exhibit 6.

[19] Lala had been losing money before its acquisition by Apple, and its value had declined precipitously. During the first quarter of 2009, Warner Music Group recorded a charge of $11 million to write-down its $20 million investment in Lala to its estimated fair value of $9 million. *See* SEC Form 10-Q, Warner Music Group Corp. (May 7, 2009). This write-down occurred only one year after Warner had made its $20 million investment in Lala. *See* SEC Form 10-K, Warner Music Group Corp. (Nov. 25, 2008).

25. Dr. Pelcovits points to the purported success of Last.FM, purchased for $280 million in May 2007 by CBS Interactive. Now, in 2010, Last.FM is a poster child for how difficult it is to create a successful, ad-supported streaming model – even with the backing of a major media company, such as CBS. According to Forrester Research, "Last.FM has struggled to find its new identity within CBS and its paymasters recently took the decision to turn off free-streaming outside of the major territories due to the inability to generate sufficient advertising revenue….further evidence of the challenges of making free pay."[20] *Digital Music News* acknowledges that "CBS appears to be struggling to properly monetize its $280 million investment."[21] Also, Last.FM's ability to attract subscribers has been lackluster to date. The CBS Interactive VP overseeing Last.FM recently admitted that it has only "tens of thousands" of paying subscribers despite self-reported traffic of about 10 million unique visitors per month in the U.S. alone, and hopes to be profitable (finally) by 2010.[22] These examples hardly paint the picture of a robust market.

E. Demographic Targeting Has Not Materialized In An Impactful Way

26. Dr. Pelcovits also touts "the ability of advertisers to obtain detailed demographics on listeners" as a revenue-driver for webcasters.[23] Beyond rudimentary IP-based geo-targeting, however, more detailed targeting is reliant on users voluntarily filling out registration forms. But most terrestrial simulcasters do not require user registration, nor do many statutory webcasters.

[20] Mark Mulligan, "Last.FM's Fond Farewell to Streaming (Sort of)," *Forrester Research*, April 13, 2010, available at http://blogs.forrester.com/mark_mulligan/10-04-13-lastfm's_fond_farewell_streaming_sort. *See* Exhibit 7.

[21] "Last.fm Flips the Subscription Switch... In Smaller Markets," *Digital Music News*, Dec. 30, 2009, available at http://www.digitalmusicnews.com/stories/032409last/. *See* Exhibit 8.

[22] Robert Andrews, "Interview: CBS Thinks Last.fm Will Turn A Profit This Year," *PaidContent*, March 18, 2010, available at http://paidcontent.org/article/419-interview-cbs-thinks-last.fm-will-turn-a-profit-this-year/. *See* Exhibit 9.

[23] SoundExchange Trial Ex. 2 (Pelcovits ACWDT), at 11.

And for good reason: there is a plethora of "no registration required" options for listening to streaming music online; hence, requiring it makes a webcaster less competitive. "Consumers are…spoiled for choice for free music on streaming sites such as Last.FM, Pandora and YouTube."[24] Ultimately, in this competitive environment, requiring registration is still the exception, not the norm.

27. Moreover, I have observed that, while targeting may increase the CPM rate for a particular demographic, the net effect may still reduce overall per-performance revenue. By way of example, a service could obtain a CPM rate of $12 for men in the 24-35 age bracket in select major markets during certain hours of the day. The problem, however, is that much smaller revenue – or even no revenue – may be obtained for listeners who do not meet these restrictions, even though the per-performance royalty rate is the same for both. Consequently, demographic targeting can and does lead to further excess inventory and lower overall per-performance revenue. In sum, targeting has yet to have any material impact on overall online radio CPMs.

F. Dr. Pelcovits Ignores The Costs Associated With New Platform Launches, And Over-Estimates The Profit Potential

28. Dr. Pelcovits identifies new features, such as song skipping and mobile access, provided by webcasters and asserts – without any authority – that such features should yield copyright holders greater royalty payments. For example, Dr. Pelcovits states that mobility "in a free market would generate additional payments to the owners of the copyright in the sound recordings."[25] While it may be true that mobility will increase listening and overall revenue, the same issue of glut and low-bucket CPMs comes into play in the mobile space. Because the

[24] Mark Mulligan, "Paying for Success: When Audiences Grow More Quickly Than Ad Revenue." *Forrester Research*, April 17, 2009 (SXW3_00018073 – 00018079), at 1. *See* Exhibit 1.

[25] SoundExchange Trial Ex. 2 (Pelcovits ACWDT), at 13.

mobile audience is a fraction of the overall streaming audience, and because more expensive video pre-roll ads and display ads are even less relevant in the overall ad mix on a mobile device, webcasters face significant challenges in monetizing this mobile audience. Thus, merely increasing audience size through mobile application does not mean that there is any increase in revenue per listener. Again, this means that services are increasing their costs without any unique way to increase their per listener revenues.

29. Moreover, Dr. Pelcovits did not take into consideration the additional cost of developing and delivering these new features. For instance, Apple's successful new portable device, the iPad, requires many webcasters to develop a new, device-specific player. Also, any of these new features are the result of web services' significant investments in creating and maintaining these players. Therefore, even if one assumes that new features (such as mobility) increase revenues, Dr. Pelcovits still fails to take into consideration the services' additional investments and costs. Finally, Dr. Pelcovits also fails to consider whether his identified new features would ultimately increase revenue *per play*, the key metric for a license that is paid on a per-performance basis.

IV. EVERY DOLLAR OF REVENUE EARNED BY PANDORA, THE MOST SUCCESSFUL STATUTORY WEBCASTER, WOULD HAVE BEEN PAID TO COVER THE SOUND RECORDING ROYALTY IN 2009

30. Dr. Pelcovits' assessment of webcaster growth is heavily skewed by a single entity, Pandora, the best-known Internet radio service by a substantial margin.[26] The positive trajectory of the "Statutory Webcasters' Aggregate Monthly Performances 2006-2009" graph on page 8 of Dr. Pelcovits' Amended & Corrected Written Direct Testimony primarily reflects

[26] The Infinite Dial 2010: Digital Platforms and the Future of Radio, *Edison Research*, at 23.

Pandora's growth, as Dr. Pelcovits himself acknowledged.[27] This is further illustrated in Table 2 (below), which derives from graphs prepared in connection with Dr. Pelcovits' report.

Table 2

As Table 2 shows, the purported "popularity" of webcasting and the upward trend in aggregate performances is almost completely a function of one service's growth: Pandora's. Moreover, over this same time period, the amount of aggregate performances by other statutory webcasting services has been flat or declining over the past few years, again undermining Dr. Pelcovits' conclusion of a robust market. Indeed, removing Pandora from this consideration reveals a very different trajectory in terms of aggregated performances, as shown in Table 3 below.

[27] Pelcovits Depo Tr. (Dec. 14, 2009) at 214:1-215:4.

Table 3

31. Further, Pandora, which "accounts for roughly 44-45 percent of total SoundExchange royalties for non-interactive streams,"[28] would not be able to sustain a viable business were they subject to the full statutory rates. From January 2009 through October 2009, Pandora reported [redacted] performances. Based on averaging the amount of monthly performances during those 10 months, one can conservatively estimate that the remaining two months of 2009 would amount to [redacted] performances. This is conservative because, historically, streaming hours rise significantly during the holiday season as people tune into holiday-themed channels and spend more time listening. Therefore, we can conservatively estimate that Pandora's total performances for 2009 were [redacted] If you multiply that

[28] "Pandora: These Numbers May Surprise You," *PaidContent*, March 18, 2010, available at http://paidcontent.org/article/419-pandora-these-numbers-may-surprise-you/. *See* Exhibit 10.

amount by the statutory royalty rate for 2009 – i.e., $.0018 – Pandora would have owed $[redacted] for only the sound recording performance royalty! **This means that just about every dollar in reported revenue that Pandora earned in 2009 – and it's widely reported to have been about $50 million – would have gone to a single cost.** Pandora's founder and Chief Strategy Officer, Tim Westergren, put it in stark terms, stating that if Pandora had not entered into the Pureplay WSA agreement, "we [Pandora] would have been done."[29]

32. A 10-year old company, Pandora represents one of the most successful, most listened-to, and most established statutory webcaster in this space. No willing buyer – much less the biggest buyer in the statutory webcasting industry – could realistically ever agree to a rate that ate up all of its revenues, leaving no money to meet other expenses or to provide a return to investors. Expecting willing buyers to pay rates through 2015 that are substantially higher than the 2009 rate – as SoundExchange proposes – is utterly unrealistic and unsustainable for the statutory webcasting industry. Therefore, this reality check refutes Dr. Pelcovits' testimony that the proposed rates "fall within a reasonable range that would be paid by a willing buyer" as not even the biggest "buyer" could afford such rates.[30]

V. INTERACTIVE AND NON-INTERACTIVE MARKETS ARE HIGHLY DIFFERENT

33. The interactive and the non-interactive marketplaces are vastly different. First, interactive or "on demand" services like Napster, which enable users to pinpoint the exact song they want to hear, serve as a celestial catalogue for listeners. Essentially, people can hear what they want, when they want it. The experience is more akin to the experience of owning a CD or

[29] John Timmer, "Pandora lives! SoundExchange cuts deal on webcasting rates," *Ars Technica*, July 7, 2009, available at http://arstechnica.com/media/news/2009/07/soundexchange-cuts-deal-on-music-webcasting-rates.ars.

[30] Direct Hearing Tr., April 19, 2010, at 163:22-164:6.

digital track that can be played on demand than it is to listening to the radio. On the other hand, Pandora and other non-interactive webcasters are essentially more tailored versions of the traditional radio experience and can be considered a "passive" or "lean back" listening experience. Second, while on-demand interactive services have faced significant challenges in growing their subscriber base, adding subscribers to a non-interactive service is even more challenging due to the plethora of free sources, such as NAB simulcasters. Consequently, ad-supported listening is the primary business model in non-interactive webcasting. Moreover, the competitive landscape for non-interactive services is much more crowded.

A. Majority Of Statutory Webcasting Is Based On Ad-Supported, Non-Subscription Listening

34. Dr. Pelcovits assumes that comparing subscription figures in the interactive and non-interactive webcasting markets will provide a suitable framework for setting rates. The flaw with this assumption is that the vast majority of the statutory webcasting listening is *not* based on subscription listening. Subscription levels for statutory webcasters are small and not growing. Live365 reports that fewer than 2% of its users are subscribers.[31] As previously stated, Last.FM's subscription users number in the tens of thousands. Rhapsody's self-reported shrinkage from 800,000 subscribers in Q1 2009 to 650,000 subscribers in Q1 2010 further bear out the difficulty of subscription-based models for online music companies.[32] And, based on my experience and observations, subscription-based streaming by NAB entities and other simulcasters is non-existent or, at best, negligible.

[31] Live365 Trial Ex. 29 (Floater CWDT), at 5.

[32] Glenn Peoples, "Analysis: Subscription Model Takes Another Hit," *Billboard.biz*, May 10, 2010, available at http://www.billboard.biz/bbbiz/content_display/industry/e3i975b286fc2a9c455fe7816e39f48bd1b. *See* Exhibit 11.

B. Statutory Webcasting Services Will Likely Continue To Be Ad-Supported And Not Subscription-Based, Unlike Interactive Services

35. On a practical level, the assumption that the webcaster can increase subscription rates significantly simply does not make sense. The vast majority of music listeners are casual listeners, some using more than one Internet service interchangeably. They listen to music that they can get for free, on their radio or from other sources, and buy few CDs or digital music files each year. The subscription services cater to a limited percentage of the public that finds music more important, and is willing to pay for the interactive service to get access to that music. The non-interactive market for the most part serves the more causal listener, who may want to hear some music, but need not be involved in selecting exactly what they want to hear. There is nothing to indicate that this more casual audience, which traditionally has not spent significant amounts on music in the past, will suddenly want to spend more of their disposable income on a service where they cannot dictate what they want to hear. Thus, based on my observations within the industry (including the evidence cited above), it is my opinion that non-interactive streaming will continue to be a mainly advertising-supported medium.

VI. NAB AND SATELLITE SIMULCASTERS HAVE SIGNIFICANT ADVANTAGES OVER NON-NAB STATUTORY WEBCASTERS

36. There is no basis for Dr. Pelcovits' establishment of the WSA agreements as the "low end" of the range of market outcomes. This assertion ignores several advantages that NAB and satellite simulcasters have over statutory webcasters. It is an understatement to say that these the business of simulcasting has a different cost/revenue structure from the operations of pureplay statutory webcasting companies. On the cost side, NAB/satellite simulcasters do not need to invest in any "start up" costs to create content to stream – they merely require a small investment to encode and deliver their existing station signals through the Internet. Years of

marketing and developing audiences for their on-air personalities and programming present an instant competitive advantage in the world of webcasting. Their stations' appeal is broad-based and programmed to appeal to a mass audience. In contrast, many statutory webcasters have more specialized formats that are not available on over-the air radio/simulcast formats and that are meant to appeal to a niche audience via their more tailored offering.

37. Additionally, simulcasters do not need to invest in a new ad sales team – they already have a team of seasoned experts who have sold audio advertising for years to local (in the case of NAB simulcasters) and national marketers (in the case of both NAB and satellite simulcasters). Also, they have a built-in source to market and cross-promote their simulcast streams: promotional or programming inventory on their over-the-air signals and station websites. It should also be noted that NAB entities historically have not had to pay sound recording performance license fees for their over-the-air broadcasts given their promotional value – despite evidence that the Internet is quickly over-taking radio as a source for new music discovery. This year, 52% of people in the 12 to 34 year old bracket turn to the Internet first to discover new music; 32% turn to radio.[33]

38. Simulcasters have many other inherent cost savings. Unlike the statutory webcaster, who must pay all of its operating costs from the revenues derived from its operations, most of the costs of the simulcaster have already been paid by the revenues of its primary operations. The offices of the simulcaster are already paid for by the primary business. Computer systems for billing, traffic (i.e., the scheduling of advertising) and for other purposes are already on hand. Other personnel (e.g., receptionists, clerical personnel, technicians and engineers, etc.) and infrastructure already exist, being paid for by the primary business of the

[33] The Infinite Dial 2010: Digital Platforms and the Future of Radio, *Edison Research*, at 16.

simulcaster. As these costs do not need to be spent on the streaming, the simulcaster can afford royalties that its webcasting competitors cannot.

39. On the flip side, the NAB simulcasters can derive higher CPMs for their inventory than can statutory webcasters. The radio groups' streams are primarily sold locally by a seasoned team of experts to an audience of buyers who have been buying inventory on their stations for years. In addition, streaming spots are frequently packaged with over-the-air inventory to maximize value for the marketer, increase online inventory-sell out rates, and command a greater piece of the marketing spend, boxing out other online radio entities. To the extent that broadcasters rely on ad networks such as TargetSpot, it is as a last resort when inventory remains unsold. TargetSpot accounted for a very small portion of total streaming revenues in my terrestrial radio experience. NAB simulcasters' selling is fundamentally local, and because it is targeted as such (and further refined by the established demographics of a station format's audience), their sales teams can and do extract higher CPMs. Statutory webcasters, in general, lack this local edge and are much more reliant on advertising agencies and networks, which take enormous commissions. In the competitive landscape of Internet radio, the business of pure play and other webcasters are clearly disadvantaged in relation to the NAB and satellite simulcasters, and thus less able to meet royalty rates. Thus, rates paid by statutory pureplay webcasting companies, not those paid by NAB stations or satellite simulcasters, should be considered the "low end" of the market outcome.

VII. STATUTORY WEBCASTING PROVIDES PROMOTIONAL BENEFITS TO COPYRIGHT HOLDERS

40. Numerous studies have confirmed the positive sales impact and promotional benefits of statutory webcasting for recording artists. NPD Group's Russ Crupnick was quoted in February of this year as stating that "online radio services lead to a 41% increase in paid

downloads."[34] In addition, Pandora CTO Tom Conrad stated in May of this year that Pandora was driving sales of 1 million songs a month, and that "for every song purchase Pandora drives, users are likely to buy 3 to 5 more songs on top of the one they found."[35] According to written testimony that was submitted by Timothy Quirk (Vice President of Programming for Rhapsody) in this proceeding, Rhapsody's internal data proves that "More non-interactive plays of a particular track correlate clearly and directly with more MP3 sales of that track."[36]

41. The above-referenced statistics directly contradict Dr. Pelcovits' assertion that "there is even more reason to believe that non-interactive (i.e., statutory) services would be as much of a substitute for purchasing music as interactive services."[37] These statistics also mitigate against Warner Music Group's W. Tucker McCrady's stated concern about webcasting becoming a "substitution" for digital sales, because statutory webcasting is clearly additive.[38] This advantage is unique to statutory webcasters versus on-demand services like Napster, Rhapsody and Spotify, which, according to the NPD analysis cited above, drives digital download sales lower by 13%.[39]

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[34] Greg Sandoval, "Pandora spurs music sales, Spotify not so much," *CNet News*, Feb. 26, 2010, available at http://news.cnet.com/8301-31001_3-10459568-261.html; *see also* Eliot Van Buskirk, "Of Course On-Demand Music Replaces Sales – It's Supposed To," *Wired Magazine*, Feb. 25, 2010, available at http://www.wired.com/epicenter/2010/02/of-course-on-demand-music-replaces-sales-its-supposed-to/. *See* Exhibits 12 & 13.

[35] MG Siegler, "The iPhone Is Accelerating Music Sales For Pandora," *The Washington Post*, May 7, 2009, available at http://www.washingtonpost.com/wpdyn/content/article/2009/05/07/AR2009050703545.html. *See* Exhibit 14.

[36] Written Direct Testimony of Timothy Quirk, Sept. 29, 2009, at 4 ("Quirk WDT").

[37] SoundExchange Trial Ex. 2 (Pelcovits ACWDT), at 35.

[38] SoundExchange Trial Ex. 7 (Written Direct Testimony of W. Tucker McCrady, Sept. 23, 2009), at 2.

[39] Greg Sandoval, "Pandora spurs music sales, Spotify not so much," *CNet News*, February 26, 2010, available at http://news.cnet.com/8301-31001_3-10459568-261.html. *See* Exhibit 12.

42. Most importantly, as a songwriter and performer, I am keenly aware of the promotional value of statutory webcasting – especially in a time where most terrestrial radio stations have been reduced to playlists of 250 or fewer songs in established musical formats. AM/FM radio's appetite for new music outside of the established formats has dwindled. In fact, only a handful of "alternative" commercial stations and formats that used to play bands like mine still exist. For the most part, the only stations that still play bands like Too Much Joy, and more obscure alternative bands, are online. The value of this exposure far outweighs the small digital performance royalties that are accorded to performers at any level.

I declare under the penalty of perjury that the foregoing is true and correct to the best of my knowledge and belief.

Alexander "Sandy" Smallens

Exhibit 1

A L E X A N D E R " S A N D Y " S M A L L E N S

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Yonkers, NY 10701
tel: 917 860 9819
email: sandysmallens@gmail.com

Summary: Digital media pioneer who has built and run profitable divisions for top media companies and start-ups in the social media, broadcast, music/entertainment and media technology industries. Flawless track record of success in revenue generation, creative innovation, cross-discipline general management and multi-platform sales. Acknowledged leader, team builder and change agent.

P R O F E S S I O N A L E X P E R I E N C E

Audiation
6/09 – Present

Founder & Managing Director

- Boutique consultancy which provides top-level leadership to start-ups and seasoned companies in the Digital and Broadcast space. Clients include the leading Social Media/Viral Marketing Agency Oddcast; the leading online branded entertainment company My Damn Channel; the largest premium ad network, AdBlade; leading urban lifestyle outlet Vibe; Turkey's largest Internet portal MyNet; music media innovators Tune Genie; and others.

Entercom Communications, Corp.
6/06 – 6/09

Senior Vice President, Digital

- Head of Digital division for top 4 radio broadcaster, reported to CEO; member of 8-person Operating Committee, which drives all corporate decisions.
- Drove Digital revenues 500% in three years, creating an 8-figure business; grew all digital traffic exponentially (sites, streams, videos and podcasts).
- Oversaw operations, staffing, strategy, business development, creation, development, sales and execution of entire business, including supervising a staff of 100 and managing 120 station websites and 90 streaming stations across 23 markets.
- Innovation milestones:
  - First radio group to launch cross-platform mobile streaming (iPhone/BlackBerry/Google phone)
  - First radio group to create a stand-alone regional sports portal which is experiencing explosive growth (weei.com)
  - First radio group to adapt open source CMS tools (Drupal, WordPress)
  - Deep integration with EveryZing (audio search engine), effectively making our audio programming searchable
  - Aggressive social networking strategies and training
  - First non-owner radio group to make their inventory available to TargetSpot (automated self-service advertising)
  - Various rich media applications and cutting-edge content development across all station formats

CBS Radio/Viacom
1/05 – 6/06

Vice President of Interactive Marketing and Sales

- Senior-most Interactive executive for largest major market radio broadcaster; reported to President.
- Directly responsible for creating and executing digital sales and business development strategy for entire 180 station portfolio, including streaming network, podcasting (including KYOU-AM, the nation's first all podcast station) and all web assets.
- Negotiated and executed category-level relationships and cross-media sponsorships with technology companies (Microsoft, Yahoo!,

Google, Real Networks, AOL), major brands and advertising agencies.
- Generated 6- and 7-figure deals with clients such as DaimlerChrysler, Monster.com, Motorola, Quiznos, Verizon and others.
- Negotiated first-ever mobile agreements for radio company, including: streaming stations over Sprint and Cingular phones; 25-station site license of SMS/MMS marketing platform; and a 'make your own ringtone' application.

Oddcast **Chief Operating Officer**
1/02 – 12/04

- Number two executive at privately-held viral marketing technology company of 25, with direct responsibility for sales, marketing, PR, and general management; reported to Founder/CEO.
- Company increased year-over-year revenue 50% in 2002 and 2003.
- Conceived, pitched products, and managed all aspects of accounts with major advertising agencies and brands such as Coca-Cola, McDonalds, MTV, Unilever, ESPN, Washington Mutual, ConAgra, Vivendi Universal, BET and L'Oreal.
- Led the successful development and launch of new products, mini-sites and initiatives in a short timespan, while managing P&L.

Vivendi Universal Net USA **Executive Vice President**
11/99 – 12/01

- Number two executive at Vivendi's consumer music portal. Managed staff of 40, reported to President/CEO.
- Oversaw creation, development, licensing, marketing and delivery of all content for GetMusic, RollingStone.com and Farmclub.com.
- Properties experienced 550% growth in unique users and traffic, and became the number two music content destination.
- Launched and successfully marketed several groundbreaking programs, including "GetMusic Karaoke"; "Videolab," which enabled users to mix their own music videos (hailed by *NY Times*, *LA Times*, *Entertainment Weekly* and many others); and "The A List," an interactive show hosted by Rolling Stone/VH1 veteran Anthony DeCurtis (guests included Michael Jackson, Kid Rock, Alicia Keys and Lou Reed).

SonicNet, Inc. /MTV **Senior Vice President**
1998 - 1999

- Managed staff of 15; reported to CEO.
- Charged with growing company from scrappy bulletin board focused on indie artists to full-blown, multi-media destination site featuring major and upcoming stars.
- Oversaw creation, development, delivery and marketing of all content for the largest online music network, recipient of 1999 Yahoo! Internet Life Award for Best Music Site, as well as three nominations for 2000.
- Produced all events, and supervised all media applications including the web's first music videos on demand site (streamland.com) and visual radio station (flashradio.com).
- Primary point person for all recording artist/record label relationships, as well as key relationships with: AOL; Yahoo!; Microsoft; Real Networks; the Vans Warped Tour; and the DMX/Jay-Z Tour.
- Acquired by MTV; member of 3-person team that transitioned company, and served as SVP at MTV following transaction.

Prodigy Internet **Vice President and General Manager**
1996 - 1998

- Managed staff of 13; reported to SVP, Content.
- Responsible for the majority of content areas on the nation's third largest ISP including music, entertainment, lifestyles, hobbies, cultures, family and education.

- Brokered all deals, negotiated contracts, developed dynamic content areas via partnering/marketing relationships and built community sites from the ground up.
- Executed high profile co-marketing deals with Warner Bros. and Atlantic Records to distribute Prodigy software on prominent music CD releases. Pioneered successful content-based retailing in such areas as cigars, music and pets.

Atlantic Records
1995 - 1996 **Senior Director, New Media**

- Managed staff of five; reported to SVP, Marketing.
- Built the record industry's first comprehensive New Media dept. from the ground up.
- Developed label and artist web sites from scratch. Executive Produced groundbreaking mixed-media CD/CD-ROM.
- Pioneered music industry use of streaming audio with history-making Tori Amos single. Strategized for the label in the digital frontier, negotiated all deals.

1993 - 1995 **Director, Media/Interactive Services**

- Oversaw staff of four; reported to VP, Artist Relations.
- Responsibilities included overseeing all online activities; creating and executing campaigns for artists on the commercial online services; and producing sites for artists.
- Created and edited all label-related media communication.

Set To Run Public Relations **Vice President, Marketing/Creative Service**
1990 - 1993

- Conceptualized and directed media campaigns and strategies for wide array of recording artists, such as: Beastie Boys, New Order, David Bowie, B-52's, the Cure, LL Cool J, and Public Enemy.

Too Much Joy **Founding Member, Composer, Bassist/Vocalist**
1987 - 1994

- Co-Founded, wrote, recorded, performed and toured with Giant/Warner Bros. four-piece satiric punk-pop band Too Much Joy. Released four major label albums and several independent ones, toured nationally as a headlining act and opening for the Go-Go's, Love Tractor, the Mekons, Violent Femmes, Gang of Four, Flaming Lips, Barenaked Ladies, Orchestral Maneuvers in the Dark, and many others. Billboard Top 15 Modern Rock act with MTV exposure.

Media Writer
1987 - 1990

- Wrote features and reviews for *Spin Magazine* and promotional materials including advertising copy, artist biographies, press releases, pitch letters and think pieces.
- Clients and artists included: John Mellencamp; Billy Idol; Soul Asylum; Sony Music Entertainment; Martin Bandier (CEO; EMI Music Publishing); and Relativity Records among many others.

E D U C A T I O N

Yale University **B.A. Political Philosophy, *cum laude***

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Exhibit 2

April 17, 2009

Paying For Success: When Audiences Grow More Quickly Than Ad Revenue

by Mark Mulligan
with David Card, Nick Thomas, Sonal Gandhi, and Erik Hood

EXECUTIVE SUMMARY

"Free" has always been the cornerstone of digital content, but the repeated failure of paid content to break out of a niche has left many content genres focusing even more keenly on ad-supported strategies. Audiences are responding in kind, spending more time with more content at more online and mobile destinations than ever before, in turn driving more content license fee payments. But content providers are increasingly finding themselves unable to square the circle of ad monetization, failing to keep pace with increased content costs. Things are coming to a head, with many content owners now seeking an even larger share of revenue just as the economic downturn starts to weaken the online ad market. To navigate through these troubled waters, content owners are having to reassess core strategic objectives and in some cases pursue counterintuitive strategies.

THE FREE CONTENT MODEL IS FACING ITS STERNEST TEST YET

From its inception, the Internet has been a predominately free content platform, and there is no indication that is about to change any time soon. In fact, the outlook for many online paid content sectors is weaker now than it was a few years ago. Against this backdrop, it is little surprise that content owners are looking more strongly to advertising revenue than ever before. But as online content audiences grow, effective monetization is becoming increasingly problematic.

- **Media industries have been infected by the contagion of "free".** The Internet has already fundamentally changed the news and music industries, and it's beginning to do the same for other sectors. Most Internet users do not and will not pay for content — it's that simple. Buyer penetration across most online content genres is in low single-digit percentage ranges. Content providers across the board have already recognized this and have embedded "free" at the core of their digital strategies.

- **Free content strategies dominate online.** For all but a few content sectors, "free" is becoming the common currency of the online experience. Virtually all news is free online, and consumers are similarly spoiled for choice for free music on streaming sites such as Last.fm, Pandora, and YouTube (not even considering the multitude of illegal alternatives). TV broadcasters are, for the moment at least, firmly on the "free" bandwagon with numerous highly successful destinations including ABC.com, Hulu, and iPlayer. Even online games providers — a relatively robust paid segment — are getting in on the act, using free casual games to entice noncore gamers. Only the movie industry continues to turn a cold shoulder to "free", though nobody has told the growing number of consumers who are downloading and streaming movies illegally.

- **Revenue models are struggling to keep up with demand.** With consumers shunning paid-for content, advertising is the key revenue source for most online services. Some of this is relatively new, some is not. But what *is* changing is the ability of monetization to keep up with audience growth. More consumers are becoming more engaged with more digital content than ever before. Consumers are watching more shows, listening to more songs, and playing more games. This is great news if your core focus is building scale, but not so great if you're focused on building sustainable business models. The simple fact is that many ad-supported content destinations are not growing ad revenue effectiveness as quickly as their audiences are growing in size and level of engagement.

Online Content Providers Are Caught Between A Rock And A Hard Place

Growing online content audiences should be something to sing about. But for many content providers, it is putting increasing pressure on the viability of their business models; they simply can't afford all of their new customers. Costs are often rising more quickly than revenue is. For example:

- **Technology costs grow as consumption grows.** For music and video providers, the more their audiences stream content, the higher the costs for streaming and — should increased demand require greater streaming capacity — also for hosting. More streams equal more, directly correlative, cost.

- **Content costs grow as consumption grows.** For content aggregators in most content genres, each time a piece of content is consumed, an extra license fee is generated. Each time a music track is streamed or a video is viewed, at least one license fee is paid. So again, more streams equal more, directly correlative, cost. The bigger your audience is, and the more they're interacting with your content, the more it costs you. At time of writing, one major streaming content provider is facing the threat of closure because its ad revenue is not high enough to support the content license fees its multimillion-user base generates. Even YouTube, with more than 300 million global users, is currently struggling to meet the financial demands of rights owners.

- **Many content owners can't afford greater audience engagement.** Great audience engagement is a key strategic objective for digital content providers, and the rise of social media has been an invaluable boon for the strategy. For those content owners that do not have per-usage license fees — e.g., most online publishers — increased engagement is a positive metric, facilitating greater loyalty and ad income. But for the destinations that pay incrementally for content consumption, greater engagement is cost straight to the bottom line. These destinations now must reconsider how to increase audience time in a more cost-effective manner, using tactics such as creating their own written editorial, forums, and user profile pages.

- **Rights owners want a bigger part of the action.** Larger players, such as MySpace.com and YouTube, have leveraged their scale to negotiate better deals that either partially or wholly leverage share of revenues to cover license costs (i.e., reducing dependency on per-stream fees). Most content providers, though, do not have this luxury. Also, revenue share and flat-fee models are coming under pressure from content owners wanting to see more money for the increased consumer activity, as illustrated by the PRS for Music's license dispute with YouTube in the UK. Content owners see strong growth in consumption of their content online, and they don't see why they shouldn't benefit from the exploitation of their intellectual property. At an extreme, some content owners feel that they are effectively being asked to fund startups with nonviable business models.

- **Improvements in ad monetization are not keeping pace with usage growth.** Many streaming destinations are cluttered with low-value, remnant ad inventory that can only command weak CPMs, and they're not growing its value as quickly as content costs are growing. This applies even for the big gorillas of the piece: Google has yet to develop a vibrant video ad business on YouTube, and it and MySpace.com both have fragmented audiences. For TV broadcasters, low consumer receptivity to video ads can restrict video ad spots in online TV shows to as little as one 30-second preroll in the UK, though this rises to four or five spots in the US. This compares to typically more than 15 minutes of ad inventory for the same show when broadcast. (though the online ads benefit from better targeting and not being skippable via DVR). Then to compound matters, the economic downturn is softening the online ad market just when these destinations don't need it.

Responses To The Challenge Are Inconsistent

All of these ingredients combine to create a toxic recipe for many online content providers. They are facing the paradoxical situation of strong audience growth threatening the sustainability of their businesses. Yet at the same time, content owners see the increased consumer engagement and seek better compensation for the exploitation of their works. Content providers are responding in diverse ways:

- **Pursuing sustainable growth.** We7 — the UK's free on-demand streaming music service — is taking a measured, comparatively low-key approach to audience acquisition, prioritizing revenue sustainability over audience growth.

- **Growing audience first.** Spotify — another European free on-demand streaming music service — has focused on aggressively growing an audience and is now expanding its ad sales team to ramp up its ad revenues.

- **Responding to market realities.** Last.fm — the social music destination — announced in March that it will start charging listeners in the noncore geographies (i.e., those countries where

ad revenue does not support costs) for the previously free service.[1] A more extreme example is ad-supported music download service SpiralFrog, which closed down its service in March, unable to reconcile its license fees with ad revenue.

- **Pulling content.** Some TV broadcasters are pulling content from online services in an attempt to protect core ad revenues, such as FX Networks pulling its *It's Always Sunny in Philadelphia* from Hulu.

These trends are not about to go away. In fact, over the coming 18 to 24 months, most content services will feel even greater pressure of the audiences growing more quickly than ad revenue. Navigating through this period will require strong understanding from both services and content owners.

RECOMMENDATIONS

HOW TO WIN WITH AD-BASED CONTENT

Illegal file sharing and streaming has helped shatter recorded music sales and could yet do similar damage to TV, movie, and games revenue. Consumers want free content, and if legitimate content providers don't give it to them, then they'll get it elsewhere. As media sales and ad spending start to feel the effect of the economic downturn, it is imperative for the content owners and aggregators to work together to ensure that the illegal sector doesn't get the upper hand during these challenging times.

- **Build sustainable audiences.** Weakened consumer spending during the downturn will create the double effect of people spending more time at home and online with more demand for free content. But product strategists — especially those who do not have extensive financial resources, are not revenue-positive at a per-user level, or who are not currently mapping to be —— should treat this opportunity with caution, and prioritize monetizing the core audience over audience acquisition. Many services will need to make the tough decision to moderate audience growth, using tactics such as trimming marketing initiatives and allowing subscribers to churn.
- **Moderate content consumption only as a last resort.** Placing restrictions on an audience's content consumption is not an option for many types of content providers, and for those that can do it, it is a strategy that should be implemented with utmost care. Essentially an alternative to moderating audience growth, this approach, done well, enables product strategists to continue to grow audiences (and therefore reach for ad revenue) and reduce the content license fee costs per user, thus enhancing margins. In addition to tactics such as placing restrictions on numbers of plays per user in given periods, content providers seeking to protect their core offerings can be more selective with releasing content online. This way, TV broadcasters can delay the arrival of shows online and limit their appearance there. Record labels can similarly delay the arrival of new releases to ad-supported services.

- **Increase audience engagement with cheaper content.** If restricting consumption is the stick, encouraging consumption of other, cheaper content is the carrot. Product strategists should reconsider how to increase audience time in a more cost-effective manner, using tactics such as creating their own written editorial, forums, and user profile pages. The content experience cannot be only about consuming content with variable licenses. Media products must bulk up on cheaper engaging content such as cheaper to license complementary info, "free" user-generated content (UGC) polls, games, etc.
- **Change business relationships.** If MySpace.com was paying a penny a stream on the 1 billion streams it reported six days after the launch of its music streaming service, it would have a monthly burn rate of about $50 million.[2] Such costs would not have been sustainable. Instead, MySpace.com created a joint venture with the record labels that ensured sustainable license fee rates and large-scale consumption. Content owners should pursue similar strategies with smaller destinations, also. A more level playing field will ensure healthier competition and better consumer choice. If destinations cannot make money, the losers will ultimately be the content owners as consumers will invariably seek out illegal alternatives. Joint ventures may not be the ideal choice for many, but they are well-suited to the current climate. They give both sides insurance: Content owners have collateral against sites' inability to drive strong ad revenue growth, and the sites know that content owners have a vested interest in ensuring that the services are successful. It sacrifices control for the sites, but if the alternative is losing content or business sustainability, then it is often a price worth paying.
- **Innovate with ad models.** As ad budgets tighten, advertisers will be increasingly cautious ,but they'll also want more bang for their buck. Smaller content destinations should use the agility their smaller scale enables and provide full-service solutions to advertisers for a high premium. For example, We7 did a full site takeover for the Gwen Stefani perfume range campaign. Providing greater flexibility and innovation, coupled with highly targeted audiences, are assets that ad-supported content destinations must leverage. Marketers should work directly with advertisers to give more exposure and engagement with their audiences than the advertisers would be able to afford, or even reach at all, on larger sites. Rich consumer data will also help provide cost-conscious advertisers with strong value for money. Product strategists whose services do not yet have audience signup functionality should encourage, though not necessarily force, their audiences to register. This can be done to provide a greater degree of free functionality to the end user, such as playlists, profile pages, bookmarks, and so on. These registered users should also be invited to participate in regular short surveys with sweepstakes prizes, both to drive richer data, but also to provide a venue for advertiser conversations with them.
- **Increase ad inventory.** Many sites underestimate their audiences' tolerance levels for advertising. If sites find advertisers that insist on paying less for ad space, then increasing the amount of ad inventory is a key means to balance the equation. Some TV broadcasters are already actively experimenting with significantly increased frequency of video ads in online

streams. Speaking on a panel at the National Association of Television Program Executives (NATPE) in January, ABC.com's Albert Cheng said that his own testing revealed that viewers could bear twice as many ads without walking away from the shows.[3] Ultimately, consumers who seek out free content accept paying something in return, whether that means viewing ads or having to use illegal sites. During the economic downturn, many consumers will spend less on media, seeking it out for free instead. Their tolerance for increased ads will to some degree inherently increase. Watch out for clutter — that devalues inventory. If sites are careful to manage ad clutter and don't show too many ads per page, they can also get away with a lot more intrusiveness (e.g., prerolls, audio ads, etc.)

WHAT IT MEANS

"FREE" WILL REMAIN THE COMMON CURRENCY OF DIGITAL CONTENT

TV broadcasters' online video strategies illustrate an industry getting smart, learning lessons from the mistakes made by the music companies. The broadcasters knew that growing audience would be much easier than effective monetization, but they equally recognized that simply not doing anything was not an answer. They recognized that giving their audiences compelling free content online would enable them to participate and even drive an otherwise disruptive process of audience fragmentation and infection by "free". This kind of long-term vision is crucial to the future of media businesses and must not be derailed by the mid-term pressures of an economic downturn.

- **Paid content audiences will be a minority.** The collective failure of the paid digital music market to grow much further than a subset of the installed base of iPod owners illustrated that it was not about to drive some format replacement cycle. It also focused the record labels' attention on alternative business models, including various ad-supported ones.[4] The record labels have recognized that services that are either free (e.g., Pandora) or that *feel* free (e.g., Comes With Music) are the most likely ways of converting the mass-market digital opportunity. These services inherently infer a lower average revenue per user (ARPU) than premium alternatives such as Rhapsody and even iTunes. But the much larger addressable audiences of free and nearly-free services means that overall revenue opportunity can be higher. But labels, publishers, and collection societies alike must recognize that current license fee rates may not be the finished article — they may require near-term tweaking to get through the economic downturn, and even longer-term changes to enable long-term economic viability. It is in the interest of all value chain stakeholders to enable these services to operate profitably and to compete with piracy.
- **Ad-supported content models will mature.** These may be challenging times for the ad-supported content sector, but business models will mature. Increased innovation will ultimately drive higher revenue per user, driving increased margins for services and stronger revenue for content owners. But the process requires patience and a better understanding

from all parties of each other's needs and strategic objectives. Content owners need ad-supported services more in a recession than at any other time. Paying customers will tighten their belts, buy fewer CDs, go to the movies less, even cancel cable subscriptions or cut back on the number of channels. Free, ad-supported alternatives provide a vital revenue safety net for those same content providers that will help them navigate through troubled waters.

ENDNOTES

[1] Last.fm announced that it will start charging listeners in all countries except Germany, the UK, and the US. Source: Richard Jones, "Last.fm Radio Announcement," *Last.HQ*, March 24, 2009. (http://blog.last.fm/2009/03/24/lastfm-radio-announcement)

[2] In comparison, it took iTunes nearly three years to get 1 billion song downloads. Source: Michael Arrington, "MySpace Music Streamed Its Billionth Song 'A Few Days' After Launch," *TechCrunch*, October 5, 2008. (http://www.techcrunch.com/2008/10/05/myspace-music-streamed-its-billionth-song-a-few-days-after-launch/)

[3] Source: Jay Baage, "ABC Says Web Viewers Can Tolerate Twice The Ads," *Digital Media Wire*, January 30, 2009. (http://www.dmwmedia.com/news/2009/01/30/abc-says-web-viewers-can-tolerate-twice-ads)

[4] The music industry is moving away from the distribution paradigm to the consumption era. Licensing from sources such as social music and subsidized subscriptions, which predominately provide consumers with music for free, will generate a further €1.2 billion in digital revenues for rights owners by 2014. See the January 20, 2009, "How Digital Licensing Will Help Save the Music Industry" report.

Exhibit 3

AdvertisingAge®

CBS Interactive Dumps Ad Networks

An Old Debate Revived: Are Networks Good or Bad for Online Media?

By Michael Learmonth

Published: December 14, 2009

NEW YORK (AdAge.com) -- Hoping to get an ad on CBS.com, Gamespot, TV.com or CNET? Better call CBS. CBS is expected to announce Dec. 14 that it will no longer do business with third-party ad networks, and will instead sell all of its considerable online inventory on its own.

In doing so, CBS re-opens a debate that raged mostly before the economy declined: Are ad networks good or bad for online media and advertising?

Former Yahoo and Martha Stewart Living exec Wenda Harris Millard splashed gasoline on the fire nearly two years ago when she admonished publishers not to allow third-party re-sellers to treat their inventory like "pork bellies." Publishers such as ESPN, Weather.com, Turner Networks, Forbes and Gawker were among the more vocal publishers to stop doing business with ad networks.

But then the economy got bad, and the debate subsided as publishers scrambled for revenue, any revenue. Now, a host of publishers are looking at the downturn as an opportunity to wean themselves off the drip-drip-drip of revenue from networks in hopes they will be better-positioned when the economy gets better. With 60 million unique visitors a month, according to ComScore, CBS is the largest single publisher to publicly make the move.

CBS
Neil Ashe
"We are prepared to take a step back on revenue if we have to, but over time we will monetize at a much better rate than ad networks do," said CBS Interactive CEO Neil Ashe.

'Madison'

Like a lot of publishers trying to decrease their dependency on third-party ad networks such as Ad.com, ValueClick or 24/7 Real Media, CBS is launching its own internal ad network so it can service advertisers that want to buy demographics or remnant display advertising across CBS sites. The company said its internal ad-serving platform, Madison, can offer audiences based on demographics or online behaviors, within CBS properties.

Mr. Ashe said CBS will also pull its inventory from some, but not all, online ad exchanges. CBS will continue to offer inventory to Yahoo's Right Media Exchange, Google's DoubleClick and demand-side exchanges such as Publicis Groupe unit Vivaki's Audience on Demand. "What we are careful not do is open our inventory to third parties that may have data interests not aligned with our own," Mr. Ashe said.

Ad networks arose en masse during the past decade in response to one problem: Publishers were generating many more ad impressions than they could profitably sell. Networks came in and offered to take that inventory and write publishers a check; they then turned around, chopped up the inventory and resold it largely to advertisers that paid by response or click.

Ad networks monetized by acquiring the inventory at as low a rate as possible, then adding sophisticated data and analytics to get a higher return. Because these were capabilities most publishers didn't have, taking the check seemed prudent. But then publishers started blaming the industry -- which grew to an estimated 400 ad networks -- for depressing ad rates across the web. Why should a marketer pay $10 for 1,000 impressions when 30 cents can probably get the same sites?

But in the meantime, much of the technology became ubiquitous -- anyone with a computer and a phone can, in effect, become an ad network. Publishers, too, could launch their own networks, and many have. Those publishers with scale, such as Yahoo, Google and Microsoft, acquired their own networks over the past decade.

Important function

Time Inc. launched its own internal network earlier in the year, and has been steadily turning off third-party networks ever since. Now it works with only one, former corporate sibling Ad.com. "Publishers have gotten smarter. We don't need to have 400 ad networks trying to do this; it only adds confusion, not clarity," said

Time Digital President Kirk McDonald.

In truth, few individual publishers alone have the scale to impact the overall market, and networks are a key part of the online ad economy. For marketers and agencies, networks perform an important function by allowing them to get huge scale and efficiency without dealing separately with dozens of publishers.

Because the first big publishers made a show of dumping networks a few years ago, "the ad network marketplace has gotten bigger," said Mike Cassidy, CEO of Undertone Networks.

As for CBS taking its inventory out of the network market, Mr. Cassidy said, "It's not that big a deal, to be honest with you; it doesn't move the market." What will, he said, is if Yahoo follows through on its promise to kick networks off its Right Media exchange that don't add significant value with data or advanced targeting.

As publishers launch their own networks, this has added some new opportunities for third-party networks both as data and technology vendors, as well as additional sources of volume when a publisher needs more reach. That, and agency buyers start with a target audience first, the publisher or website second. If a certain campaign doesn't require a specific site (say, iVillage vu.s Babycenter), then the networks are going to be part of the buy.

"If you want to do something cool with a publisher, then buy directly," said Andy Atherton, CEO of Brand.net. "If you're buying standard media, networks offer a more efficient way to transact, regardless of your objective."

Exhibit 4

paidContent.org
THE ECONOMICS OF CONTENT

Music Social Network Imeem In Play; Hires Bank; Laying Off 25 Percent

Rafat Ali @rafatali

Oct 22, 2008

Online music-focused social network **Imeem** is on the block, according to our sources, and has hired investment banker Montgomery and Co. to lead the sale. Coincidentally, we have also learned that the company is announcing some layoffs internally today—as much as 25 percent of its around 80-strong workforce. These layoffs are mainly on the technical back end and services side.

The company has done its on-demand streaming music deals with all four majors, and has also been working with a slew of indies. As it has built out its platform (**it recently relaunched** its site/service), and done most of the biz dev deals, the focus now is on growing audience and monetizing the platformit won't be needing as much technical expertise going ahead, the sources say, and hence the layoffs. Of course, Imeem is a Sequoia-portfolio company, which means it is all but obligated to heed to the VC firm's recent call of cost and employee cuts.

Lots more after the jump...

Why sell? On the sale, the company's thinking is that despite the economic troubles and music industry's continued troubles, the time is right with lots of activity in the sector—the hype around MySpace Music's launch, the imminent launch of Facebook's own music service (and for now, iLike's dominance there), and music becoming part of a bigger social media play—and the company would do well as part of a bigger one. It has been in the process of raising more money from strategic investors, some of whom have expressed an interest an acquisition. **The company has previously said it has about 30 million registered users, and 100 million users across its network** of widgets/apps and through usage on other social sites. On the actual making money side, its efforts are more recent, and it has been focusing on branded experiences with advertisers, something similar to what Pandora also does.

Imeem has raised above $50 million in funding over the last two years, including a $15 million round from Warner Music Group (**NYSE: WMG**) **earlier this year**. Other previously disclosed investors include Sequoia Capital and Morgenthaler Ventures**we have also learned that DAG Ventures was the last one to invest in the company this summer, with the valuation north of $200 million**. They would probably like more than that, but with the current market, anything in nine figures would be, well, reality-rational.

The Palo Alto-based company earlier this year acquired **Snocap**, the digital music start-up founded by Shawn Fanning. Last year, it resolved a copyright infringement lawsuit brought by WMG by striking a rev share deal.

While we're at it, who is going to **put Pandora out** of its streaming-royalty misery?

Related

- **Music Social Net Imeem Gets More From Sequoia**
- **Social Net Imeem Buys Struggling Music Service Snocap**
- **Warner Drops Suit Against Imeem, Swaps Access For Rev Share**
- **Searching For a Business Model in La La Land: Lala Tries Again With Another Music Service**
- **Facebook Wants Music, But Doesn't Want To Tangle With Labels**
- **MySpace Music: First (Real) Look: For Once, You**

Can’t Blame The Lawyers

Exhibit 5

TechCrunch

Ok, Now It's Done. MySpace Music Completes Acquisition Of iMeem

by **Michael Arrington** on Dec 8, 2009

MySpace Music has completed its acquisition of most of the assets of music service iMeem.

We first broke the news that MySpace was close to **acquiring iMeem** last month. Two days later, we reported that an **agreement was signed** to purchase the assets of the company for $1 million in cash.

The deal didn't close, however, because some of the assets MySpace Music was going to buy (namely, servers) were actually being leased. So that had to be **worked out**. And the final price ended up being less than $1 million, meaning MySpace Music is getting the iMeem brand and users for next to nothing. An additional earnout is also part of the deal, but it's not much.

Unlike the iLike acquisition, iMeem is being acquired by MySpace Music, not MySpace. MySpace Music is a **joint venture** between MySpace and the music labels.

But now it is **official** . MySpace Music will be acquiring some of iMeem's remaining assets and transition its 16 million monthly users over to MySpace Music. All of their playslist swill be migrated over, for instance. Founder Dalton Caldwell, CTO Brian Berg, COO Ali Aydar, and VP of Sales David Wade will oversee the transition on a consulting basis. It is not clear what will happen to IMeem's other employees. Imeem now redirects to this l**anding page** .

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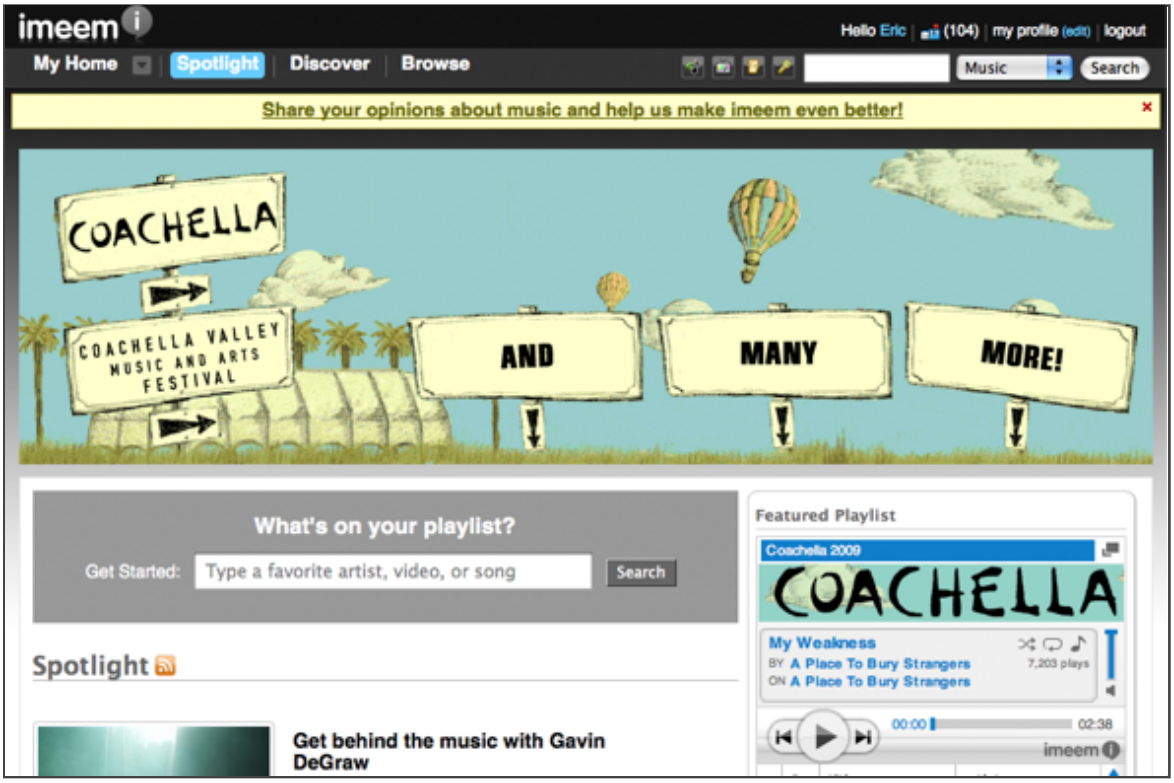
Exhibit 6

Music startup imeem making money, not dying unless the labels kill it

March 26, 2009 | Eric Eldon
3 Comments Share

Sure, the music industry — including music startups — are having trouble coming up with significant online music business models, but recent rumors circulating about imeem's money problems appear to be exaggerated. The San Francisco company, which lets users create and share streaming song playlists, has been reportedly running out of money, especially because of how much it has to pay for music licensing deals it has with record labels.



Imeem isn't commenting on finances. It says it's not profitable. So far, it's been focused on advertising, but now it is also focusing on e-commerce revenue from things like digital song sales, ticket sales, and other non-advertising services. But I also hear the company's advertising effort has been working to some degree. It is getting "much higher" rates for banner ads than MySpace Music and other competing web sites, one source says, because its users are focused on music, not on more general social networking features. Recession-driven advertiser cutbacks have hurt imeem, but the results so far of its direct sales team could mean more money down the road. Meanwhile, a new feature for letting users buy entire imeem playlists through iTunes has doubled the company's iTunes revenue. Other features, like its VIP, freemium and ticket sales services are still too new to judge the results of.

But what about paying the bills now? Imeem was one of the first online music companies to work out a licensing deal with all four major record labels, and the terms are onerous, with the company possibly having to pay up to a penny to the labels for each song its millions of users stream. Rumors have been going around Silicon Valley and the music industry about immediate financial issues, with one being that they owe labels up to $30 million. Both the company and our sources say it is far less — in the single-digit millions. Imeem also periodically restructures its deals with the labels,

There are a truly impressive number of rumors going around about the company. One I've heard is that its valuation has fallen from what was (or still is?) "north of $200 million" to something far less; the company isn't commenting on that. Another is that its

investors, including its venture capitalists like Sequoia Capital as well as record labels, now own a very large portion of the company.

So either because of licensing alone or also equity, the labels hold power over imeem. More on what that might mean, from Wired:

> *When we asked, Warner Music Group would not comment on whether it would consider dropping the per-song rates it charges imeem. However, we've also heard indication that the labels could ultimately decide to let various online businesses perish under these on-demand rates, in the hope that eventually, one of them will be able to sustain the high on-demand music licensing rates they require regardless of the economy. For imeem, the day of reckoning could be approaching, although nobody we spoke to could envision imeem disappearing any time soon.*

Imeem has up until this point had one of the most comprehensive streaming deals with labels; rivals like Project Playlist are still working to get approval from some of them. Which just goes to show that the music labels are providing the wrong mix of incentives here. They make fickle and costly licensing deals with only som companies, then tax them as they try to operate. The labels might be able to get more entrepreneurs invested in music startups again (yes, many have moved on) if they make a clear set of rules for licensing, then minimize or drop the tax while imeem and other music startups try to figure out their products and business models.

[**Update:** MediaMemo reports that imeem has reached a new agreement with some of the labels, including Universal Music Group but not Warner Music Group. TechCrunch has a good analysis of the state of the industry -- which is that labels are more or less killing streaming music startups.]

[**Update II:** The company has recently had a recent management shakeup, with top business executives departing.

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Imeem

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imeem is the world's leading social music service, enabling music fans to discover, interact and express themselves with music and playlists, and connect with other people based on shared tastes and...More»

Overview

LOCATION: San Francisco, CA, United States

INDUSTRY: Consumer Internet

EMPLOYEES: 30

TAGS: Video, Playlist, music, Web 2.0, Community, discovery, Snocap, anywhere.fm, internet

Financials

LATEST FUNDING: Debt - $6M (09/2009)

INVESTORS: Morgenthaler, Warner Music

Market

COMPETITORS: Pandora, blippr, BuzzNet, Maestro Music, Inc., Oosah, Mixwit, Listal, Qloud, thesixtyone, The Hype Machine, MySpace, Yoogli Music, Hyves, Shastic, iSound, Jamendo, Music.com, MusoCity.com, Music Nation, Jogli, Bandcamp, Anywhere.FM, JukeFly

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MySpace Acquires imeem Social Music Service for a Song

NOV 18, 2009
MySpace Signs Agreement To Acquire iMeem

Exhibit 7

Last.FM's Fond Farewell to Streaming (sort of)

By *Mark Mulligan*
Created *04/13/2010 - 08:16*

Last.FM have announced that they will stop streaming full on demand songs to users, instead providing integrated streaming from 3rd parties. [1] Though this certainly highlights some of the challenges in today's on-demand streaming music business it says less about the fundamentals than it might first appear to do.

This is one more chapter in the Last.FM / CBS integration story. Last.FM was an early mover in the streaming music and had tens of millions of users when Spotify was just a twinkle inn Daniel Ek's eye. Many – myself included – were surprised by the $280 million that CBS paid just under three years ago to acquire Last.FM. Since then Last.FM's fortunes have been a mixed bag. Though user numbers are at an all time high, Last.FM has struggled to find its new identity within CBS and its paymasters recently took the decision to turn off free-streaming in outside of the major territories due to the inability to generate sufficient advertising revenue.

CBS are doing what you would expect a major media organization to do with an expensive start-up acquisition: they are trying to make it contribute to the bottom line. These objectives often do not align closely with the innovative vision that drive start-ups to scale and market profile, though usually not to profitability.

Profitable streaming requires the long view. Making streaming music profitable is a long term market-level play that requires patience and value chain partnership. Streaming services say rights holders need to drop their fees further than they have already done so. Rights holders say they need to see streaming services deliver revenue more and threaten sales less. CBS have decided that they are not willing to wait for the music industry to get its house in order and pay the expensive mortgage whilst doing so. Instead they've opted for rented accommodation in the form of supporting links from approximately 600 streaming partners, including Spotify, the Hype Machine and Vevo.

Some revenue will now slip through the cracks. It's worth noting that not all of the content from all of those partners will be 100% legal. For example the Hype Machine collates links from numerous blogs, many of which post unlicensed content. So a portion of Last.FM's streaming revenue will simply disappear rather than migrate to other services.

The bottom line is that CBS has made the call that Last.FM does not need to host streaming to deliver a differentiated music discovery experience. Is a hosted solution likely to deliver a better quality experience than relying on partners? Absolutely, but not better enough to justify the much higher expense for CBS.

When streaming rates and streaming revenues become better aligned (and they will, eventually) CBS may decide to buy back into the streaming music game. Until then it has the opportunity to focus on going back to its roots and strengthening its core value proposition: social music discovery. This isn't a nail in the coffin for free but it is further evidence of the challenges of making free pay.

3

Recommend this post [2]

Cloud Services Last.FM Mark Mulligan Music Music Industry Meltdown Record Labels Social Music Streaming Music Consumer Product Strategy

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Links:
[1] http://blog.last.fm/2010/04/12/yes-it-does
[2] http://blogs.forrester.com/plus1/vote/4139

Exhibit 8

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Jobs

Coordinator
tinyOGRE Entertainment
New York, NY

Front-end Developer (UI/Front-end)
TuneUp Media

Senior Digital Music Product Manager
Amazon
Seattle, WA

Web Developer/Site Manager
Znak Inc.
USA, UK (freelancers can tele-work from their own homes/offices)

Sr. Product Manager
Universal Music Latino
Miami, FL or Los Angeles, CA

Product Specialist (Inbound Sales)
Audiolife
Greater Los Angeles Area

Web Developer
Disney Music Group
Burbank, CA

Community Manager
Disney Music Group
Burbank, CA

Director of Product Management
TuneUp Media

Chief Marketing Officer
Berklee Music
Boston

Senior Account Manager, Digital Music
Amazon
Seattle

Senior Account Manager, Disc On Demand
Amazon
Seattle

Flat

Last.fm Flips the Subscription Switch... In Smaller Markets

Author Info

Wednesday, December 30, 2009

Last.fm is finally spinning a subscription-based offering, at least outside of the US, UK, and Germany. In smaller markets, access to the custom-tailored, Last.fm radio service will soon cost 3 euros ($4.05) per month, according to the company. The rest is free, including recommendations, scrobbling, and networking, core components of the Last.fm model.

In the bigger markets, that same charge removes ads from the radio service, one that contains roughly seven million songs. Just like Pandora or Slacker, the Last.fm radio station fine-tunes over time, based on the tastes and preferences of the user. Sounds fun and engaging, though Last.fm disclosed that sales were simply not generating enough capital outside of its core markets.

Or, perhaps within the core markets. Increasingly, ad-supported, online media companies are struggling against bottom-scraping valuations, including YouTube. Whether Last.fm has better targeting remains unclear, though its concept is a bit more focused. Still, Last.fm has nothing near the traffic volumes of YouTube, and CBS appears to be struggling to properly monetize its $280 million investment. The changes go into effect March 30th.

• View Comments Flat

Exhibit 9

paidContent.org
THE ECONOMICS OF CONTENT

Interview: CBS Thinks Last.fm Will Turn A Profit This Year

Robert Andrews **@robertandrews**

Mar 18, 2010

After its 2007 acquisition, it doesn't seem like CBS (**NYSE: CBS**) has been able to get the most from its $280 million Last.fm outlay. There's been no TV scrobbling, no profit, the site's key execs have left and fitting the trendy Silicon Roundabout, London, startup in to a U.S. megacorp appears to have been a challenge generally.

But now CBS has reined Last.fm in to its interactive music group, with direct oversight from president David Goodman. **Speaking to me** after we came off a panel at MediaGuardian's Changing Media Summit on Thursday, the unit's product VP Fred McIntyre offered some new insight**Listen!**

The subscription business drives about a quarter of Last.fm's revenue. **It has paying subscribers in the high tens of thousands, McIntyre said** - that's way low compared with Spotify's 320,000, gained after just a year and a bit.

Our plan is to be profitable with Last.fm in 2010. We're very bullish on the subscription service. We'll be rolling out some new features around the subscription service in Q2. The U.S. is now a quarter of Last.fm's overall audience.

Expect upcoming announcements about incorporating Last.fm's scrobbling feature, which notes users every track listen, on other sites. Last.fm has recently done this with Shazam and We7.

Exhibit 10

paidContent.org
THE ECONOMICS OF CONTENT

Pandora: These Numbers May Surprise You

Digital Music News

Mar 18, 2010

For years, Tim Westergren was on the front lines of a difficult royalty battle. But instead of becoming a casualty, **Pandora** and other internet radio providers managed to forge a workable rate structure - at least one that kept the lights on.

But this is still one huge royalty bill, and Pandora is now one of the biggest contributors. Just recently, Westergren disclosed top-line, 2009 revenues of $50 million, but royalty obligations to SoundExchange alone (a cost that does not include publishing) topped $28 million, according to Westergren.

The bigger Pandora gets, the bigger its royalty bill, a variable cost structure that makes it difficult for many content-based business to scale.

Either way, Pandora is a serious chunk of total SoundExchange royalty revenues from online radio. Despite all of the wrangling over non-interactive royalties on recordings, Pandora now accounts for roughly 44-45 percent of total SoundExchange royalties for non-interactive streams, according to details confirmed by both companies. We're about 44 percent of internet radio, Westergren told Digital Music News.

Beyond that, Pandora represents a very important one-percent of broader radio royalties. We're a shade over 1 percent of the overall radio marketplace, Westergren relayed. Multiply that by 100, and you get the found revenue flowing to labels and artists if we were in an internet radio world instead of a broadcast world.

This story has been provided by our content partner **Digital Music News**.

Exhibit 11

Analysis: Subscription Model Takes Another Hit

May 10, 2010 - **Digital and Mobile**

By Glenn Peoples, Nashville

If music subscription services were easy, everybody would be doing them and millions of Americans would be paying. Numbers from RealNetworks' latest earnings show subscriptions are still one of music's greatest paradox: so much potential but so few paying customers.

Rhapsody finished Q1 2010 with 650,000 subscribers, according to its earnings release last week, a 3.7% decline from 675,000 at the end of Q4 2009 and down 18.8% from 800,000 in Q1 2009.

It's a familiar refrain. **Napster** was losing subscribers before it was acquired by Best Buy in September 2008 and hundreds of thousands more were lost when AOL shut down its subscription service. (Napster paid for AOL's 350,000 subscribers in January 2007, bringing its total to about 900,000. Since Napster's subscriber count stood at just over 700,000 in June 2008, it can be reasoned most of them didn't stick around.)

Not long ago, Rhapsody was gaining subscribers. At the end of Q4 2007, according to a RealNetworks SEC filing, Rhapsody had 775,000 subscribers after adding 150,000 net new subscribers in Q3 and 25,000 in Q4. In 2008, the company launched a multi-million-dollar advertising campaign around its Music Without Limits initiative that included a new MP3 store, a partnership with Verizon (VCast) and full-song previews at iLike. By the end of Q3 2008, Rhapsody had competed a one-time migration of customers from Yahoo! Music's shuttered subscription service.

Now, media darling **Spotify** has 300,000 paying subscribers and over seven million users of its free service in six markets. It's a good start, but nothing more. To put it in perspective, Spotify has fewer paying customers than Rhapsody and Napster have lost in recent years. The game-changing gains have been made by only one company: **Pandora**.

The timing of Rhapsody's Music Without Limits campaign couldn't be more coincidental. In the same month, Pandora launched its hugely successful iPhone app. It can't boast eight million on-demand tracks, but it obviously has enough music for a large section of the market. Most impressively, Pandora achieved a rare feat by the end of 2009, less than a year and a half after it launched its iPhone app: it turned a profit. In contrast, competitors are struggling to acquire users to scale to profitability.

The final verdict on the current subscription model has not been delivered, but its outlook is grim. New

competitors are needed in the U.S. market to breathe life into a staid situation and, for a change, excite consumers. Given consumers ambivalence about today's subscription market, it's no wonder labels and publishers are desperately hopeful that partnerships with ISPs and device manufacturers will bring new life to subscriptions.

Pandora, however, provides reason for caution on subscriptions. The runaway success of a service with a small catalog and no ability to grant on-demand access – the exact opposite of the services most favored by content owners – shows people may be overestimating the demand for a celestial jukebox.

Links referenced within this article

Digital and Mobile
http://www.billboard.biz/bbbiz/industry/digital_mobile.jsp
according to a RealNetworks SEC filing
http://sec.gov/Archives/edgar/data/1046327/000095013409002615/v51492exv99w1.htm
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Exhibit 12

CNET News
Media Maverick
February 25, 2010 6:39 AM PST

Pandora spurs music sales; Spotify not so much

by Greg Sandoval

Update 2-26-10, 6:17 a.m. *To include quotes from Spotify and to clarify that NPD's numbers were for U.S. only.*

NEW YORK--Free on-demand music sites haven't fared very well when it comes to driving song sales.

Russ Crupnick, an analyst with market researcher NPD Group, told a crowd of music and tech executives here Wednesday that free streaming-music sites, which enable people to listen to any song at any time free of charge, lead to a 13 percent decrease in paid downloads.

Speaking at the Digital Music Forum East conference, Crupnick sized up the situation this way: "We're eating our young. For some people, more listening just means more listening and tends to lead to less purchasing."

By contrast, online radio services lead to a 41 percent increase in paid downloads, Crupnick said.

Pandora, the best-known Web radio service, doesn't enable people to choose songs but plays ad-supported music randomly.

NPD's figures, which covered the U.S. only, are just the latest bad news for the ad-supported music sector. Very quickly, the concept of free music is losing credibility as a business model with the record companies.

This is what they see: a long list of failed attempts. Last year, SpiralFrog and Ruckus closed their doors, while Imeem avoided such a fate by selling itself for peanuts to MySpace.

Only Pandora has shown a profit, and that's just for one quarter.

By all appearances, what this means is that the ability to log on to a site and listen to any song without paying a cent appears to be in jeopardy.This also means Spotify, the on-demand service that has taken Europe by storm, and is planning a U.S. launch sometime in the spring, may struggle to get some of the labels on board--at least if it's pitching an on-demand, ad-supported service.

Edgar Bronfman, Warner Music Group chairman, very publicly voiced his skepticism about the ad-supported model earlier this month when he said: "Free streaming services are clearly not net positive for the industry."

Thomas Hesse, Sony Music Entertainment's digital chief, said at the Digital Music Forum that he was pleased with Spotify's efforts to convert customers from the company's free service to a subscription offering. He said Spotify is getting double-digit conversions in some areas. As for a U.S. launch happening this year, Hesse said, "I'd bet $10 for Spotify launching in the US...they have a lot going for them."

"We've (got) a long way to go, that's for sure," said Jim Butcher, a Spotify spokesman on Friday. "Having only been around for just over a year we're not going to be providing overnight answers to a longer-term decline--but we're confident we have both the model and the service to make Spotify a success and combat the fundamental problem here--that of music piracy and how we as an industry convince music fans to enjoy music in a legal environment."

Whether Spotify launches next year or next week, such services one day soon will need to figure out how to make money, said Kevin Bacon, owner of Artists Without A Label.

Bacon, whose company has worked with Radiohead's Thom Yorke, Moby, and the Arctic Monkeys, said during a panel discussion that he loved Spotify's platform as did many of the acts he represents. But he lamented that, for all the company's neat technology and huge following, it passed very little compensation back to the artists.

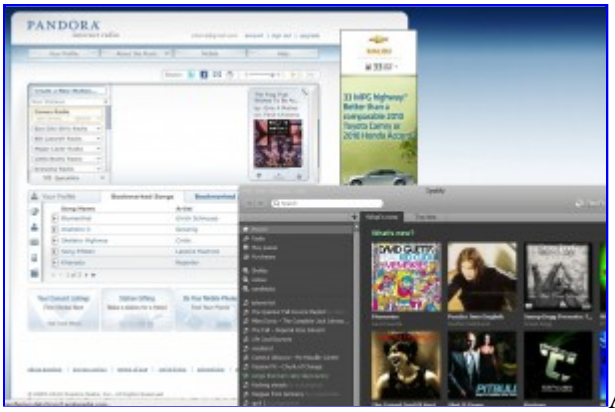
"As far as revenue, it's not really meaningful at all," Bacon said. "It's frustrating. The artists see Spotify and get excited. But when they see the revenue from it, it's insignificant."

Greg Sandoval covers media and digital entertainment for CNET News. He is a former reporter for The Washington Post and the Los Angeles Times. E-mail Greg, or follow him on Twitter at @sandoCNET.

Exhibit 13

Of Course On-Demand Music Replaces Sales – It's Supposed To

By Eliot Van Buskirk ✉ February 25, 2010 | 5:12 pm | Categories: Media, Social Media



At the Digital Music Forum East in snowy New York, executives gathered to hear new data comparing what happens to music sales when people use interactive radio services such as Pandora as opposed to subscribing to unlimited streaming services such as Rhapsody and Spotify.

The Pandora-like radio model has a promotional effect on music sales, increasing them 41 percent, according to NPD's data. Meanwhile, streaming services that let users hear just about any song they want, such as Spotify, cause people to buy 13 percent less music.

This is understandable — after all, the whole point of an on-demand music service is that you can hear whatever you want, whenever you want, without buying anything. However, senior industry analyst for NPD Group Russ Crupnick drew a surprising conclusion from the data:

"We're eating our young," Crupnick told attendees, according to CNET. "For some people, more listening just means more listening and tends to lead to less purchasing."

The key here is that Pandora ≠ Spotify. One is a radio, the other a record collection.

But it's not a bad thing for the industry that on-demand services like Spotify and Rhapsody replace sales — that's what they're designed to do. It's no accident, and neither is the much-higher premium — a penny per stream — that labels and publishers extract from them, which is ten times more what streaming radio sites pay.

If everyone paid a penny every time they played a song on their computers without buying a single song, the record industry would be in far better shape than it is now. More listening doesn't need to mean less money, even if it means less purchasing. But for some reason, that model is seen as "eating our young," when compared to the pay-per download model, which is essentially the electronic version of buying an unbundled

CD, cassette, or 8-track tape — all formats that have become considerably less attractive to most people as they increasingly listen on connected devices, if they listen at all.

Among ad-supported websites, only YouTube and a few others can afford to offset those high on-demand music rates, in part because they show video ads. Another option is to charge for a monthly music subscription. That's tough to do, which is why Napster has struggled and Rhapsody seems to have plateaued around 700,000 subscribers — respectable, but not a homerun.

The key here is that Pandora ≠ Spotify. One is a radio, the other a record collection.

The record industry's only problem with Spotify is where it draws the line between the free version, which lets you hear almost anything whenever you want if you put up with a few ads, and the paid version, which costs 10 Euros per month and lets you store songs in a mobile app — comparable to Rhapsody in the states, but more expensive than MOG, neither of which offers as much for free as Spotify does.

What will be interesting, if Spotify launches in the U.S. later this year, will not be its effect on sales, but rather how restrictive its free version is compared to the one currently available in Europe. Either way, it's no emergency for the music business that on-demand listening has been shown to replace music purchasing, even though other digital music services increase sales. It's all in how they're designed, and the copyright holders get paid either way.

Consumers have shown that they increasingly want to stream music more than they want to download it, and will continue to move in that direction as more of our devices become connected. In light of that, the industry's idea that the music download market must be protected at all costs could hamper a move to cloud-based music that could ultimately give more people more reason to pay, even if they purchase less. Besides, they're not even purchasing much music as things stand anyway.

The full version of Spotify costs the equivalent of $13.50 per month, while the average U.S. consumer typically spends less than twice that on all music products in a full year. Meanwhile, MOG's lower-priced streaming subscription (which it is able to offer by having to offset an unlimited free version the way Spotify does), charges $60 per year. A move away from purchasing doesn't have to be a move away from spending, but it can be a move away from profits.

See Also:

- Google's Music Strategy: Past, Present and Future
- Music: Too Expensive to Be Free, Too Free to Be Expensive
- Free, Ad-Supported Music … With a Twist
- MOG's $5 Monthly Music Service Highlights Spotify Obstacle

Tags: mog, music sales, on-demand music, pandora, spotify
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Comments (7)

Posted by: mystixa | 02/25/10 | 8:40 pm |

Exhibit 14

The Washington Post

The iPhone Is Accelerating Music Sales For Pandora

MG Siegler
TechCrunch.com
Thursday, May 7, 2009 1:53 PM

Pandora is a company that mainly makes its money through advertising deals on its streaming Internet radio service. But a growing portion of the business is also affiliate downloads of songs that users hear on Pandora and want to buy on either iTunes or Amazon's MP3 service. And the biggest mover accelerating growth in that regard are downloads taking place on the iPhone.

Users are buying about a million songs a month now from these affiliate links on Pandora, CTO Tom Conrad tells me. Of those, a solid 20% are coming directly from Pandora's iPhone app, which includes an easy link to open the iPhone's iTunes app, and buy a track. That's really impressive considering that it's just one phone that a relatively small percentage of their users use.

But really, I'm not surprised by this at all, because Pandora has always been a brilliant music discovery service. And when paired with the iPhone, you have an all-in-one new music machine. And Pandora was actually the top downloaded app on the iPhone for all of 2008. But last month, when Apple completed removing DRM from all its iTunes tracks, it created an even a greater incentive to buy music that way. Now, I can buy music on the go, sync it back with my computer when I get home, and listen to it anywhere.

Another feature driving affiliate sales is the bulk music purchase option. This allows you to bookmark songs on Pandora, and with one click buy them all on either iTunes or Amazon. 10% of web users who are buying music through Pandora are using this bulk buy feature, Conrad says.

Here's an interesting way to think about these affiliate sales. If Pandora is selling 1 million tracks a month, that's $12 million in sales a year (though Apple and Amazon make the majority of that). But Pandora is still only less than 1% of all radio when you take into account the terrestrial and satellite varieties. Say hypothetically that Pandora made up 100% of radio, the potential sales of these affiliate tracks would then by $1.2 billion a year, as Conrad notes.

That of course is very unlikely to ever happen, even in Pandora's wildest dreams, but still Conrad says that from Pandora's own research, they know that for every song purchase Pandora drives, users are likely to buy 3 to 5 more songs on top of the one they found. At this 100% model, that would make Pandora a $3.6 to $6 billion a year business.

Why play such a hypothetical? Well because the *total* recorded music industry revenue last year was only $4.6 billion. Affiliate links can be big business on the web and on mobile.

Even before the iPhone app, Pandora was one of the top affiliate purchase drivers for Amazon and iTunes. And amazingly, their main competition wasn't other online music sites, but instead was search and shopping engines like shopping.com. Given the boost Pandora is already seeing from the iPhone in this regard in just a matter of months, it seems pretty clear that mobile purchases could be a big deal down the road.

And just imagine if Apple one day lets apps access iTunes right from within the apps to ease the process even more. With in-app purchases coming in iPhone 3.0, something like that could be possible one day.

Before the
COPYRIGHT ROYALTY BOARD
LIBRARY OF CONGRESS
Washington, D.C.

In the Matter of	)	
	)	Docket No. 2009-1, CRB Webcasting III
DIGITAL PERFORMANCE RIGHT IN SOUND RECORDINGS AND EPHEMERAL RECORDINGS	)	

LIVE365'S CLARIFICATION REGARDING TERMINOLOGY & THE OPERATIONS OF LIVE365

INTRODUCTION AND BACKGROUND

1. My name is Johnie Floater, and I am the General Manager of Media at Live365, Inc. ("Live365"). I previously provided a written direct statement in this proceeding, and my background and current job duties are included in that testimony.

2. On April 28, 2010, during the direct hearing for the above-captioned proceeding, Judge Roberts asked Live365's counsel to provide clarification during the rebuttal phase about the terms used by Live365's witnesses and how they relate to Live365's business operations.[1] I am submitting this statement on behalf of Live365 in response to Judge Roberts' request.

LIVE365 TERMINOLOGY

3. I understand that my testimony, and the testimony of other Live365 witnesses, contained various terms that may have been inconsistent. This statement attempts to clarify those inconsistencies.

[1] Transcript from Direct Hearing in Docket No. 2009-1 CRB Webcasting III ("Direct Hearing Tr."), April 28, 2010, at 1362:18 - 1363:17.

4. Live365 exclusively transmits non-interactive digital audio transmissions via the Internet. It is not, and never has been, a terrestrial radio broadcaster. In dealing with its listeners and the webcasters who stream programming through Live365, the company employs the terms "broadcasting" and "broadcast" to mean "webcasting" and "webcast." Thus, when Live365 testimony referred to our "broadcasters" or "broadcast services," Live365 witnesses were referring to "webcasters" or "webcasting services," unless it was specifically in response to a question about terrestrial broadcasting operations. For Live365, "Internet radio broadcasting" and "Internet broadcasting" are synonymous with "webcasting." Live365's internal nomenclature is to call all webcasters "broadcasters." Further, we define these webcasters by the packages they purchase – i.e., personal and professional packages.

LIVE365'S WEBCASTING SERVICES

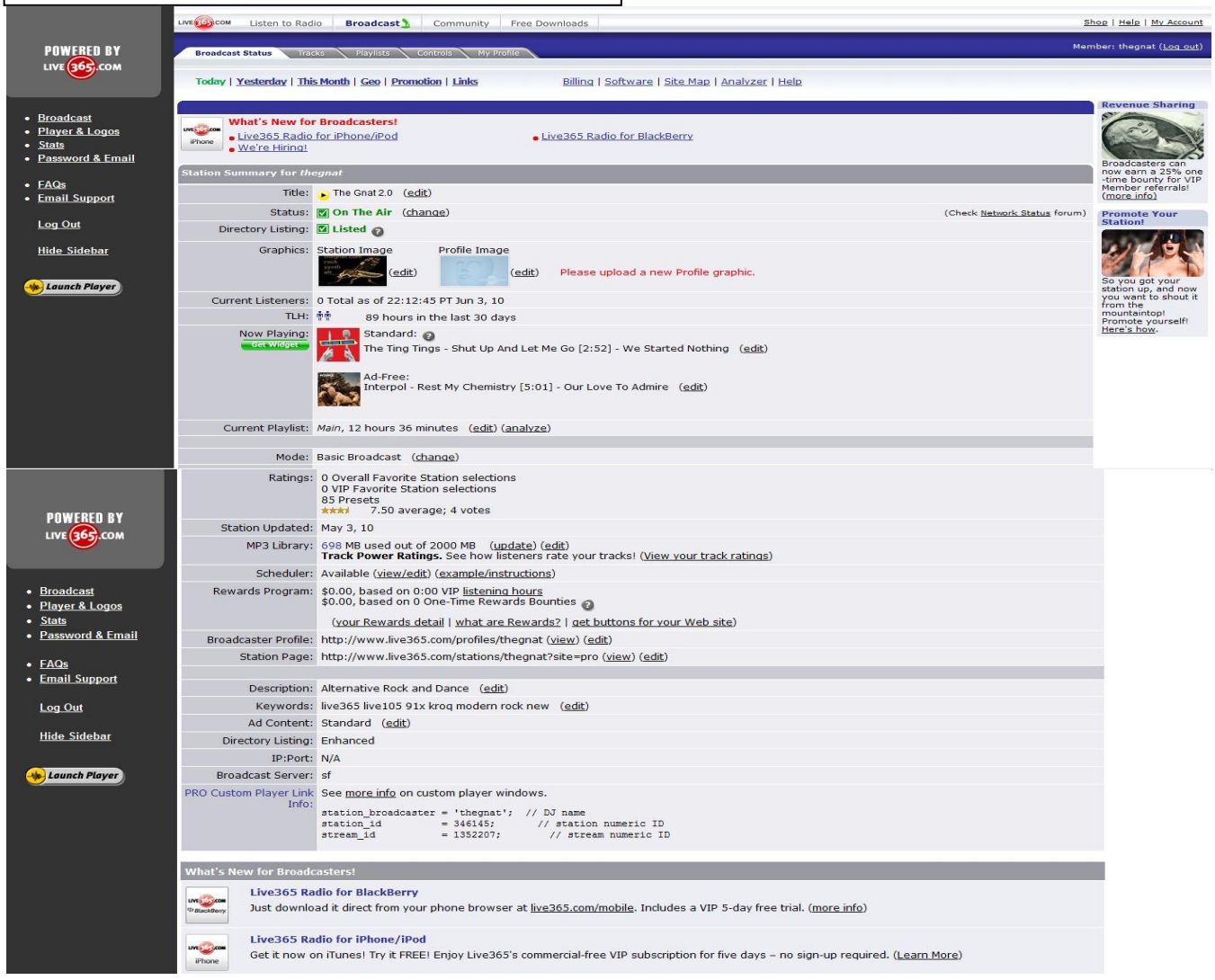
5. Live365 offers various webcasting (referred to by Live365 as "broadcasting") packages and services to individuals and entities that wish to transmit non-interactive digital audio transmissions via Live365's Internet servers. Live365 offers essentially two webcasting packages: (1) personal webcasting (referred to by Live365 as "personal broadcasters"), and (2) professional webcasting (referred to by Live365 as "professional broadcasters"). The primary differences between the two categories of webcasters are set forth in the table below.

Features	Personal Webcaster	Professional Webcaster
Station Launch	Personal webcaster's station is launched from Live365's web page.	Professional webcaster's station may be launched from Live365's web page and/or from webcaster's own web page.
Advertising	Live365 audio ads are inserted in-stream into Personal webcasts.[2]	Live365 audio ads are not inserted in-stream into Professional webcasts. The Professional webcaster may independently insert audio ads into their webcast.
	Live365 graphic banner advertising is placed on a Personal webcaster's station page (which is located on Live365.com).	No Live365 banner advertising is placed on the Professional webcaster's independent, non-Live365 webpage. However, Live365 graphic banner advertising is placed on a Professional webcaster's Live365 station page.
	Live365 inserts pre-roll advertising prior to launch of all Personal webcasts.	Live365 does not insert pre-roll advertising into Professional webcasts launched from the Professional webcaster's independent webpage. However, Live365 does insert pre-roll advertising when the webcast is launched from the Live365 website.
Digital Sound Recording Performance Royalty ("DSRP")	Personal webcaster's DSRP royalty obligations are covered under Live365's license.	Professional webcaster may elect to have DSRP royalty coverage under Live365's license ("Royalty Included Package"), or may obtain their own license ("Standard Package").
Storage Capacity	Moderate server storage space.	Large server storage space.
Live365 Directory Listing	Personal webcaster's webcast will be aggregated and listed on Live365's Internet radio directory for listeners to access.	Professional webcaster may opt out of being aggregated and listed on Live365's Internet radio directory.

[2] At the direct hearing Judge Wisniewski asked whether Live365 webcasters received any revenue share or credits for having Live365 ads inserted into their streams. *See* Direct Hearing Tr., April 26, 2010, at 1021:3-1021:13 and 1034:6-1034:21. Audio ad revenues are not shared with personal webcasters; however, ad revenues allow Live365 to competitively price our webcasting services to make them more affordable for thousands of potential webcasters.

6. To better illustrate Live365's webcasting services, I have included various screenshots from Live365.com's webcaster pages. Below is a screenshot of a Live365 webcaster's home page, which shows the user interface to access the tools and services necessary to stream digital audio signals over the Internet. *See* Image 1. This is a dedicated page that is seen only by Live365 webcasters; it is not seen by the general public. As this screenshot demonstrates, a Live365 webcaster's home page provides, among other things, analytical data regarding listeners, listening hours ("TLH"), and allocated server storage space.

Image 1 – Live365 Webcaster's Home Page



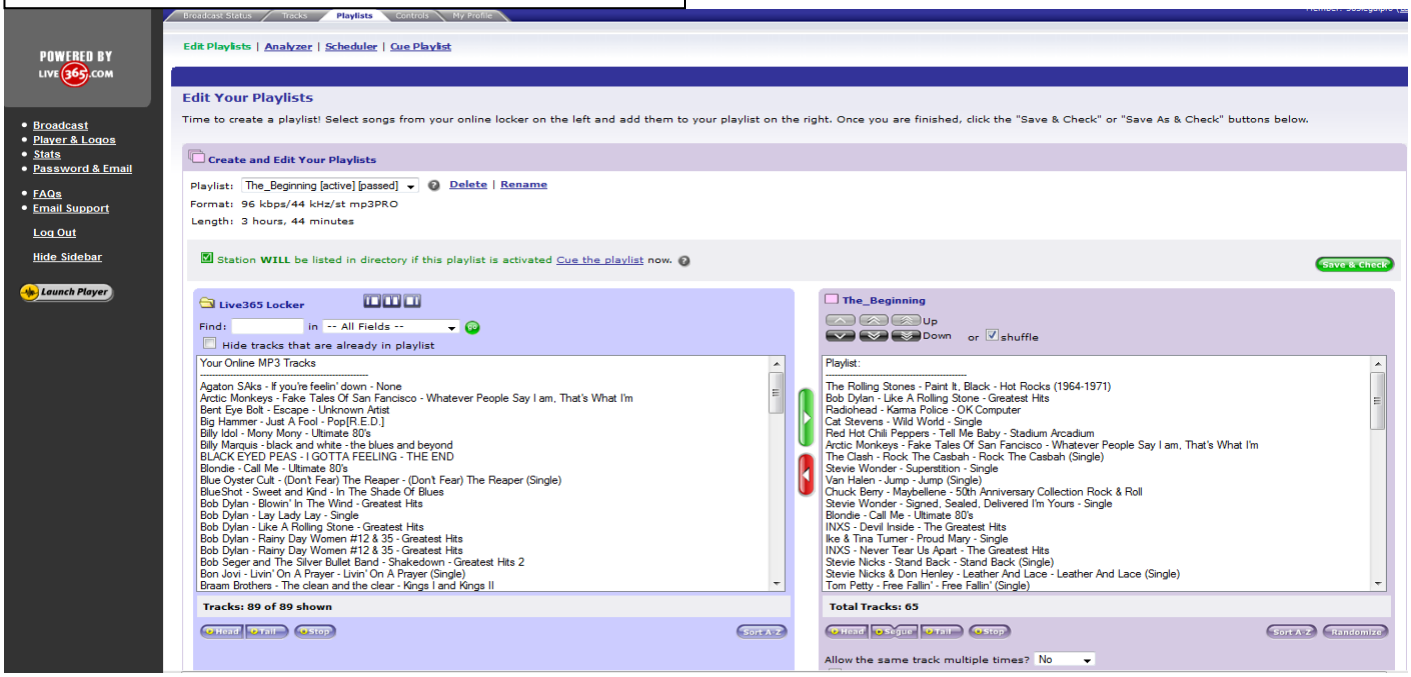
7. Below is a screenshot of Live365's webcasting "geo" statistics page, which allows Live365 webcasters to analyze where their streams are being heard and the amount of time their webcasts are listened to in the different geographic regions. *See* Image 2.

Image 2 – Live365 Webcaster's Geo Statistics Page

Cities	States	Streams	TLH
Evansville	IL, IN, KY	12	21:59
Atlanta	AL, GA, NC	8	7:45
San Francisco - Oakland - San Jose	CA	2	2:01
Nashville	KY, TN	1	1:42
New York	CT, NJ, NY, PA	5	1:08
Chico - Redding	CA	2	1:01
Orlando - Daytona Beach - Melbourne	FL	1	0:30
Philadelphia	DE, NJ, PA	1	0:18
Chicago	IL, IN	6	0:17
Sacramento - Stockton - Modesto	CA	1	0:16
Boston (Manchester)	MA, NH, VT	1	0:16
Washington DC (Hagerstown)	DC, MD, PA, VA, WV	8	0:16
Pittsburgh	MD, PA, WV	1	0:11
Houston	TX	4	0:03
Buffalo	NY, PA	2	0:03
Los Angeles	CA	1	0:01
Madison	WI	1	0:01
San Diego	CA	1	0:00
Flint - Saginaw - Bay City	MI	1	0:00
Miami - Fort Lauderdale	FL	1	0:00
Oklahoma City	OK	2	0:00
Baltimore	MD	1	0:00
Hartford & New Haven	CT	1	0:00
Minneapolis - Saint Paul	MN, WI	1	0:00
Totals:		**65**	**37:59**

8. Finally, below is a screenshot of a Live365 webcaster's playlist control page, which enables a webcaster to arrange and program their webcasts based on digital audio files they have stored on Live365's servers. *See* Image 3.

Image 3 – Live365 Webcaster's Playlist Control



LIVE365 INTERNET RADIO SERVICE

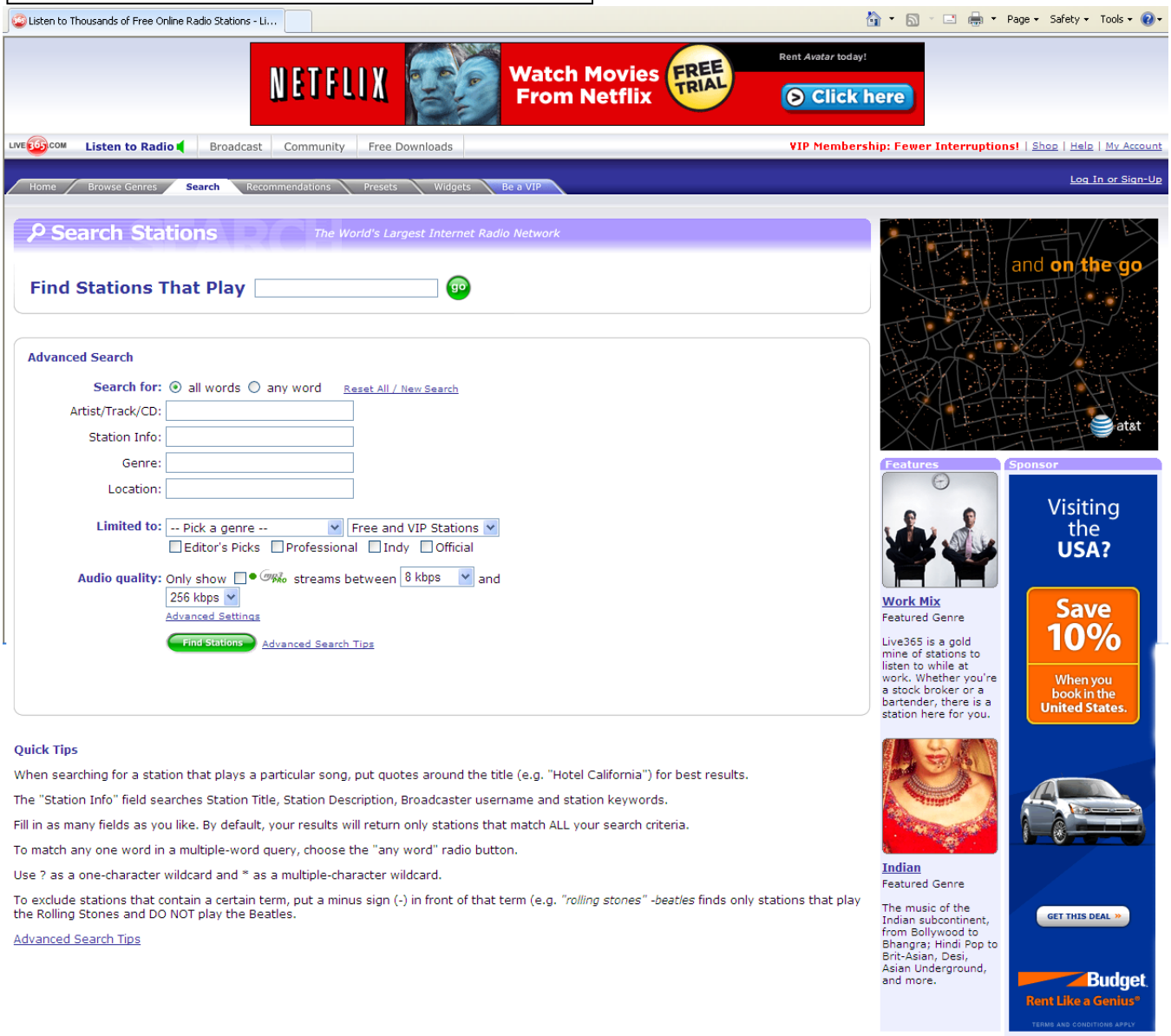
10. In addition to the webcasting services offered by Live365 to webcasters, Live365 provides a non-interactive listening service to individuals that wish to listen to Internet radio. Specifically, Live365 aggregates the various webcasters who have produced programming through the Live365 webcast platform and places them into a listening directory, which then can be accessed by the public at Live365.com. Our Internet radio service, which is used by millions of people, is similar to ones provided by Pandora and other statutory non-interactive Internet radio companies. And similar to other pureplay statutory webcasting services, we generate revenue by both advertising and subscriptions.

11. To better illustrate Live365's Internet radio service, I have included relevant screenshots. Below is a screenshot of Live365's Internet radio listening home page found at www.live365.com, which provides listeners access to thousands of Internet radio stations. *See* Image 4.

Image 4 – Live365 Internet Radio Listening Home Page

12. Live365's Internet radio service offers the ability for a listener to find webcast stations based on the webcaster's location, the type of music streamed, audio quality and other criteria.[3] Below is a screenshot of Live365's Internet radio service's search page. *See* Image 5.

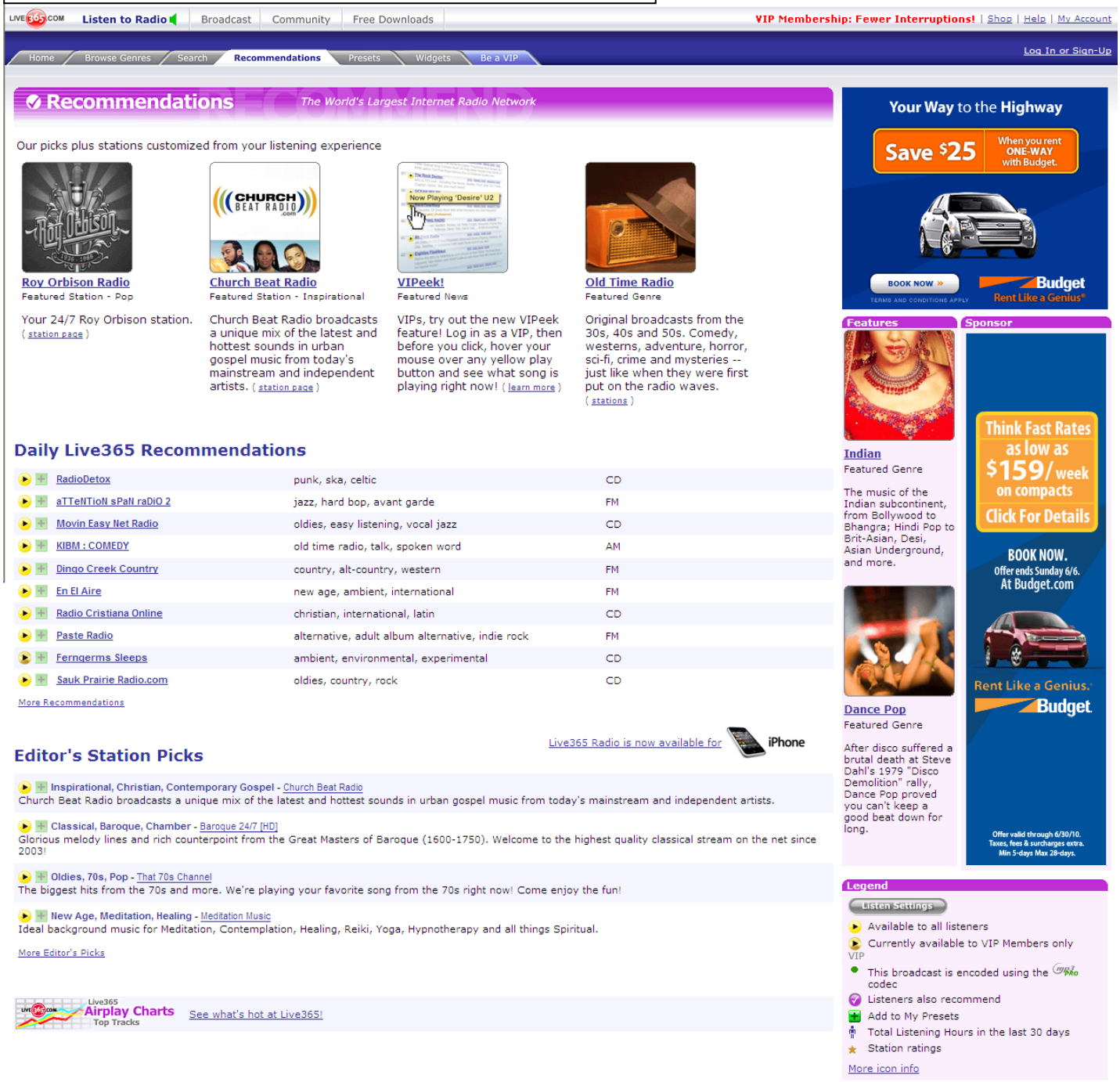
Image 5 – Live365 Internet Radio Search Page



[3] Listeners can search by song title but Live365's system only lists webcasts that have the searched song in their library, thus giving the listener a sense of the webcast's format. The search functionality does not allow a listener to actually find a station that is contemporaneously playing the song that is inserted into the search field.

13. In addition, Live365's Internet radio service provides recommendations to listeners by highlighting webcasts, genres of music, and artists to expose listeners to a wide array of content. Live365's "Recommendations" web page is displayed in the screenshot below. *See* Image 6.

Image 6 – Live365 Internet Radio Recommendation Page



CONCLUSION

14. As discussed above, Live365 has two lines of businesses. The first is the webcast services division which allows thousands of webcasters to program content that is stored and streamed on Live365's Internet servers as non-interactive digital audio transmissions. The second is the Internet radio division which provides an online radio platform for listeners to access and enjoy the content Live365 streams through the Internet. It is within the confines of these two business lines that various terms were used by me and other Live365 witnesses during the Direct Hearing.

INSERT SIGNATURE PAGE

CERTIFICATE OF SERVICE

I, Rhea Lytle, a secretary with the law firm of Davis Wright Tremaine LLP, do hereby certify that copies of the foregoing "**REBUTTAL STATEMENTS OF LIVE365, INC.**" were sent via electronic email and via Federal Express, this 7th day of June, 2010 to the following:

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