PUBLIC VERSION

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

In the Matter of	)	
Mechanical and Digital Phonorecord Delivery Rate Adjustment Proceeding	)	**Docket No. 2006-3 CRB DPRA**

TESTIMONY OF ALAN McGLADE

1. My name is Alan McGlade and I am the President and Chief Executive Officer of MusicNet. I submit this testimony in connection with the Written Direct Statement of the Digital Media Association ("DiMA") in the above-captioned proceeding for setting rates and terms for the making and distribution of digital phonorecord deliveries ("DPDs").

2. MusicNet is a United States corporation organized under the laws of the State of Delaware, with offices in Seattle, WA, New York, NY, and London, England. With over eighty employees worldwide, we provide the infrastructure, features and functionality, content licensing, reporting and payment services, and other expertise to our distributors to enable them to offer a range of cutting-edge, personalized subscription music services to consumers.

3. Before joining MusicNet, I was President and CEO of The Box Music Network ("The Box"), an early interactive music television channel. The Box was acquired by Viacom, Inc. in 2000 and combined with MTV2. From 1991 to 1995, I served as President of StarNet, a pioneer in providing marketing, advertising, and information services to the cable television

industry utilizing digital technology. In 1985, I founded and served as President of Adlink, the first satellite-delivered cable television advertising interconnect, which grew into the United States' top grossing cable advertising distribution service.

4. I make this statement on the basis of my personal knowledge, which I have acquired through my experience in entertainment and interactive businesses, and as a result of my review of the documents appended to this statement. To the extent that the facts and matters set out in this statement are within my knowledge, they are true. To the extent that I have relied upon the information provided by others, my testimony is made to the best of my knowledge, information, and belief. I identify the instances in this Testimony in which I rely on sources other than my own personal knowledge.

I. SUMMARY OF TESTIMONY

5. MusicNet is a leading online digital music company offering business-to-business digital music streaming, conditional downloading and permanent downloading services over the Internet. The company was founded in 2001 by Warner Music Group, Bertelsmann AG, EMI and RealNetworks. In April, 2005, 100% of the company was purchased by Baker Capital, a private equity firm. The company remains privately held.

6. MusicNet is a business-to-business provider of digital music services to ISPs, consumer electronics companies, offline and online retailers, offline and online media companies, and others. We differentiate ourselves from other players in the online digital music industry by offering a wholesale infrastructure solution to our distribution partners rather than directly marketing a retail service to consumers. As a business-to-business provider, MusicNet

provides to its distributors the ability for them to offer a completely customized solution for their consumer-facing digital music delivery service, including a library of licensed content, technology and music delivery systems tailored to their audiences. MusicNet's platform enables distribution partners to achieve speed to market, reliability, and scalability as well. In choosing to work with MusicNet, distribution partners can maintain complete control of their brand, customer relationships, and customer account information. In return, MusicNet is able to achieve extensive reach through its distribution partners' marketing and established customer base. Unlike other digital music services that sell subscription and permanent downloads directly to consumers, we seek to provide services to a massive customer base of brand-name distributors, without incurring the significant marketing expenses required for customer acquisition.

7. MusicNet has invested nearly [redacted] dollars in technology infrastructure and products for the sole purpose of providing digital music services to our customers and to their end users. By efficiently enabling our distributors to provide such services at a lower cost and more expeditiously than they could do it themselves, we maximize the availability of creative works in the marketplace and create a value chain that benefits all parties from creators to end customers. As a result, MusicNet makes it easier for creators to get their works to the broadest audience and get compensated for it. We enhance the ability of distributors to add value to their existing customer relationships by providing a turnkey music solution we can customize to their needs. Distributors, for their part, commit to marketing the service and maximizing its reach, and listeners get a compelling music experience for a competitive price.

8. Ongoing investment in the business is crucial because the music marketplace is intensely competitive and our success is dependent on a number of factors, some in our control and some not. We compete primarily with the pervasive availability of "free" music on peer-to-peer ("P2P") services. Despite the highly public lawsuits and demise of many well-known P2P sites, Internet piracy is far from dead. Additionally, there are a number of technological issues still to be resolved around digital rights management including portability of content, and access to the widest range of platforms, all of which deter wider consumer adoption.

9. Despite our best efforts, it remains very challenging to explain the value of subscription services to users and, given the lack of consumer adoption to date, it's a hard sell to potential distributors to invest in offering subscription services. As wholesalers, our margins are narrow. Our business success is driven by scale -- but it is hard to get distribution in the marketplace when returns on investment in this sector remain unproven. Finally, content costs overall need to be in line with marketplace realities if the market is going to provide adequate returns to make the investments worthwhile.

10. For all of these reasons, the rate set in this proceeding should not prevent us from establishing the viability of our unique business model or make it more difficult than it already is to gain traction in the marketplace. We are one of the good guys -- providing a legitimate alternative to piracy so that composers and musicians get paid in a world where too many people are stealing from them. We need to be able to grow that business and prove the benefits we offer are real for everyone involved.

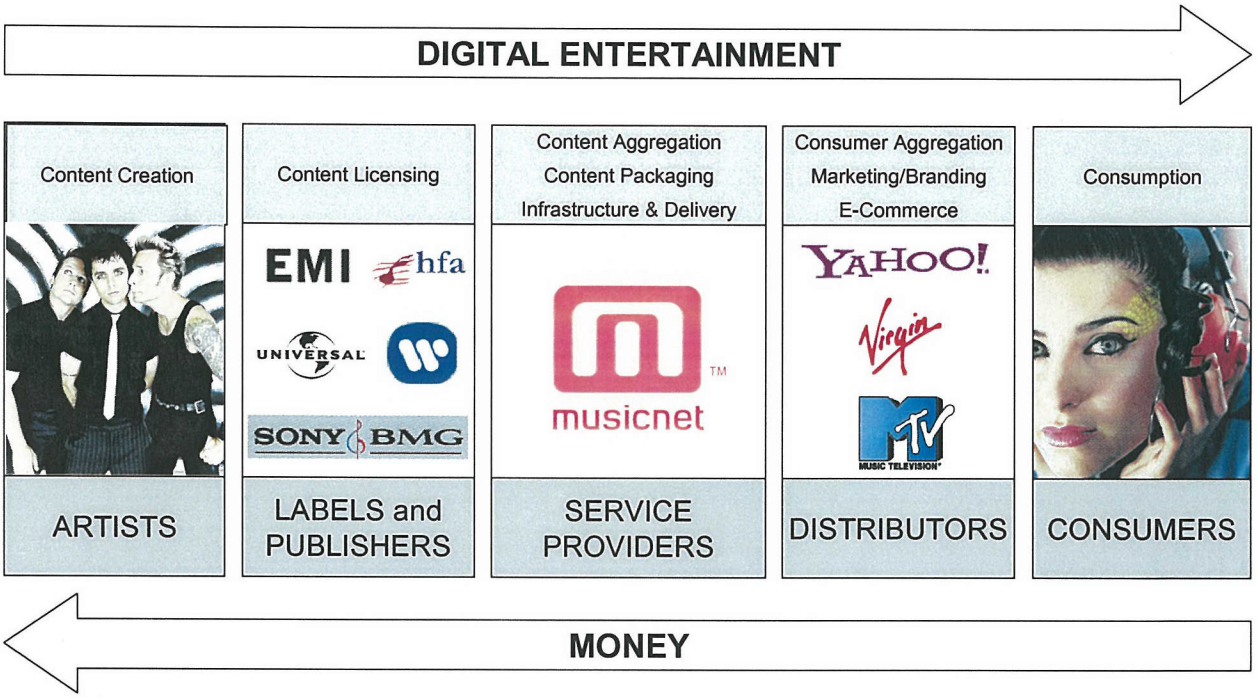
II. MUSICNET IS CREATING A BUSINESS INFRASTRUCTURE FOR DELIVERING CONTENT TO CONSUMERS AND ADDING VALUE TO EVERY PARTICIPANT IN THE MARKETPLACE

11. The music industry is in a new age. It is not hard to imagine a world in which CDs are relegated to the same fate that befell eight-track tapes almost thirty years ago. MusicNet's unique offering enables the creation of an end-to-end value "chain" delivering content to consumers and compensating music creators in turn, growing the marketplace in the process. Our business model offers significant benefits to listeners, distributors, and creators of music. We are making it easier for content to reach paying customers and turning more casual listeners into active fans who spend money on music.

A. OUR UNIQUE BUSINESS MODEL ENABLES EASIER ADOPTION OF SUBSCRIPTION MUSIC OFFERINGS AND MAXIMIZES AVAILABILITY OF THE SERVICE TO CONSUMERS

12. Many brand-name online and offline companies who wish to offer digital music services to their customers do not want to deal with the complexity of developing a technology infrastructure and delivery system because they require a constant upgrade with new features and functionalities on a regular basis to remain marketplace competitive. Brand-name online and offline companies also do not wish to deal with securing rights from content owners and reporting and paying such parties. MusicNet addresses these hurdles on their behalf. We bring together content creators, acquire the full range of necessary licenses, provide the technology platform to integrate with distributors, customize solutions for unique demographics, and handle as much or as little of the end-user relationship as appropriate. As a result, we provide substantial benefits in the marketplace and create tremendous value for creators of musical works.

MusicNet's Central Role in the Digital Marketplace



13. MusicNet has invested substantial time and effort in establishing the widest possible network of distributors for our subscription and download services, including consumer electronics companies, online and offline media companies, wireless service providers, online and offline retailers, universities, broadband providers, and technology companies, and we continue to do so. MusicNet's primary goal is to provide subscription services and download stores for its network of partners. We accomplish this in numerous ways, from turnkey to deeply integrated custom solutions. In order to achieve this aim, MusicNet is responsible for licensing agreements with labels and publishers, the software platform responsible for delivery of assets and licenses, reporting, billing, and payment services (to content owners). Some examples of the types of MusicNet distribution partners are described below.

14. Wireless Service Providers — MusicNet is partnering with leading wireless service providers in order to provide a one-stop digital music experience to wireless consumers that includes song samples, full songs, video, artist images, charts, and playlists. MusicNet's current backend infrastructure supports subscriptions and permanent download sales direct to cellphones.

15. Online and Offline Media Companies — Our current distribution partners for such services include well known brands such as Yahoo! and MTV as well as others. MTV Networks, a unit of Viacom Inc., is one of the world's leading creators of programming and content across all media platforms. MTV Networks, with more than 100 channels worldwide, owns and operates the television programming services -- MTV, VH1, CMT, NICKELODEON, COMEDY CENTRAL, LOGO, among others. URGE is a digital music service from MTV Networks that offers complete access to the MusicNet catalog of over two million songs, eighteen music genres, countless styles and exclusives from MTV, VH1, and CMT. URGE features hundreds of playlists, radio stations, music feeds, blogs, as well as interviews and articles from leading music voices.

16. Yahoo! provides users with access to a collection of resources through its various web portals, including various communications tools, forums, shopping services, search services, personalized content, and branded programming. Among the Yahoo! offerings is Yahoo Music Unlimited, a music service that allows users to download or subscribe to MusicNet's catalog of millions of songs, either through their personal computer or with any number of handheld devices that are compatible with the service. The Yahoo! service recommends select songs, albums, and artists to users based on their personal preferences. In addition, Yahoo! subscribers

can share music online with other Yahoo! subscribers, listen to the music catalogues of other Yahoo! subscribers, and can share each other's radio stations. Yahoo! also offers numerous pre-programmed radio stations and charts tracking its most popular songs, artists, and albums.

17. Technology Companies — Our partners include [redacted]

18. Consumer Device Manufacturers — Our distributor, MusicGremlin, Inc. has created a wi-fi device that allows users to discover, purchase, manage, control, and legally share their digital music collections directly from their digital audio players, wirelessly and without requiring a personal computer. MusicGremlin's technology allows devices that contain the MusicGremlin software to access the MusicGremlin Direct music service and download tracks directly to such devices using wireless high-speed networks. MusicGremlin's end-to-end system benefits content owners by providing a secure and exciting new distribution channel, and MusicGremlin's device technology benefits consumer electronics partners by providing next-

generation functionality to their digital audio products. It also benefits consumers by giving them the instant gratification of accessing any song directly from their device.

19. We also partner with a company called CDigix, which provides colleges and universities with a leading, Internet-based solution for digital music, user generated content, and educational materials. CDigix's primary mission is to enable college students, faculty, and staff to consume, connect, and communicate via digital content. Launched in 2004, CDigix's digital music service is currently offered at dozens of colleges and universities around the country. In many instances, CDigix's offers the music service free to students.

20. Synacor is a MusicNet partner that distributes content through broadband portals, including Adelphia, Charter Communications, Roadrunner and others. Synacor is a leading provider of premium service delivery platforms and private-label portals that enable broadband portals to easily bundle a wide variety of free and subscription-only value-added services into their Internet offerings. Their technology allows its broadband portal partners to offer a premium music service, which offers consumers the MusicNet library of sound recordings for download or subscription.

21. With over [redacted] subscribers through our distributors as of November 2006, MusicNet is currently the leading provider of backend digital music services over the Internet. We have made substantial investments in international distribution as well.

B. WE OFFER SUBSTANTIAL BENEFITS AND EFFICIENCIES TO OUR DISTRIBUTORS, WHICH ULTIMATELY BENEFITS CONTENT OWNERS

22. By offering distributors multiple solutions for music services, we achieve not only significant economies of scale and scope but enhance the ability of subscription services to penetrate the marketplace. MusicNet distributors take advantage of our expertise and investments to further leverage their customer relationships and provide valuable services downstream to consumers. We provide value in several ways.

23. First, our programming strategy includes developing and acquiring comprehensive label catalogs, proprietary content, and exclusive content. We maintain strong relationships with the major and independent record labels, and continue to successfully expand our content offerings. We have music licensing agreements with all four of the major record labels as well as hundreds of independent labels. MusicNet can now offer listeners over 2.6 million songs from which to choose and expects to add another [redacted] songs by the end of this year.

24. MusicNet also creates distribution partner-specific programming initiatives that cater to targeted audiences and genre preferences within a distribution partner's consumer base. Proprietary programming may include genre-specific playlists and custom charts designed exclusively for a distribution partner. In addition, MusicNet works with its content providers to develop exclusive content, including artist interviews and performances. MusicNet also secures and makes available to its distributors "pre-released" content prior to commercial release in record stores. MusicNet has offered exclusive content from Coldplay, Mary J. Blige, Annie

Lennox, Liz Phair, Ashanti, Beastie Boys, Lenny Kravitz, Todd Rundgren, Blake Shelton, and The Strokes, among other artists.

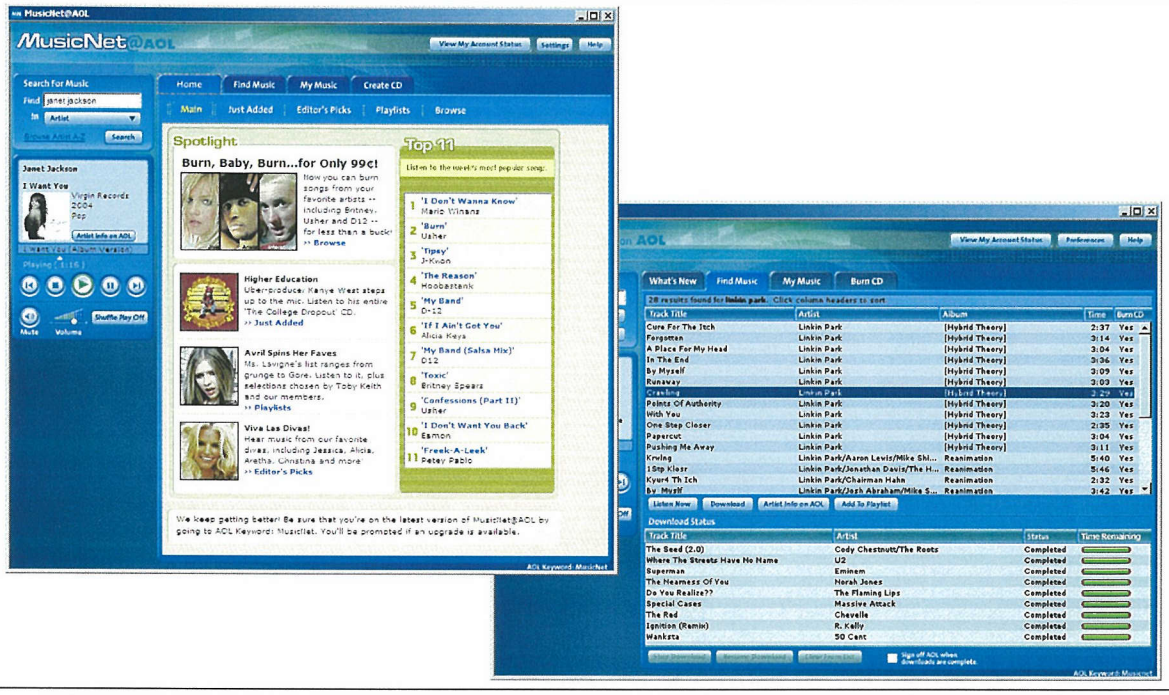
25. Second, MusicNet provides technology to develop and manage all underlying operations needed to build branded premium music subscription and permanent download services. This includes, for example, delivery and playback of content to consumers, managing and applying use restrictions imposed by content owners (*e.g.*, managing the number of personal computers that can be registered to a music service by a single consumer), and interfacing with e-commerce systems. The elements that make up the MusicNet platform can be deployed in multiple configurations depending on a distribution partner's needs. The software integrates into technologies the distribution partner wants to use. These technologies include consumer-facing applications (*e.g.*, media player, web site), content distribution networks, search technologies, recommendation technologies, e-commerce, user login, and account management applications.

26. We have invested [redacted] of dollars to date to develop the MusicNet platform, *see* MusicNet Capital Investment Analysis, Exhibit A, and we continue to invest in enhancements so as to improve the functionality and flexibility of our offerings to both distribution partners as well as to consumers. Future software investment will always be required to fund the development of new and innovative features and functionality for our fully developed music service platform.

27. MusicNet works hand-in-hand with its distribution partners to develop each partner's digital music strategy and service offerings. Each partner comes with its own set of technology requirements and a pre-existing backend infrastructure. For example, a partner may

already own or control a media player or require one from MusicNet. MusicNet has the capability of integrating into a partner's media player or integrating its media player into its partner's service.

Custom Integrated Interface

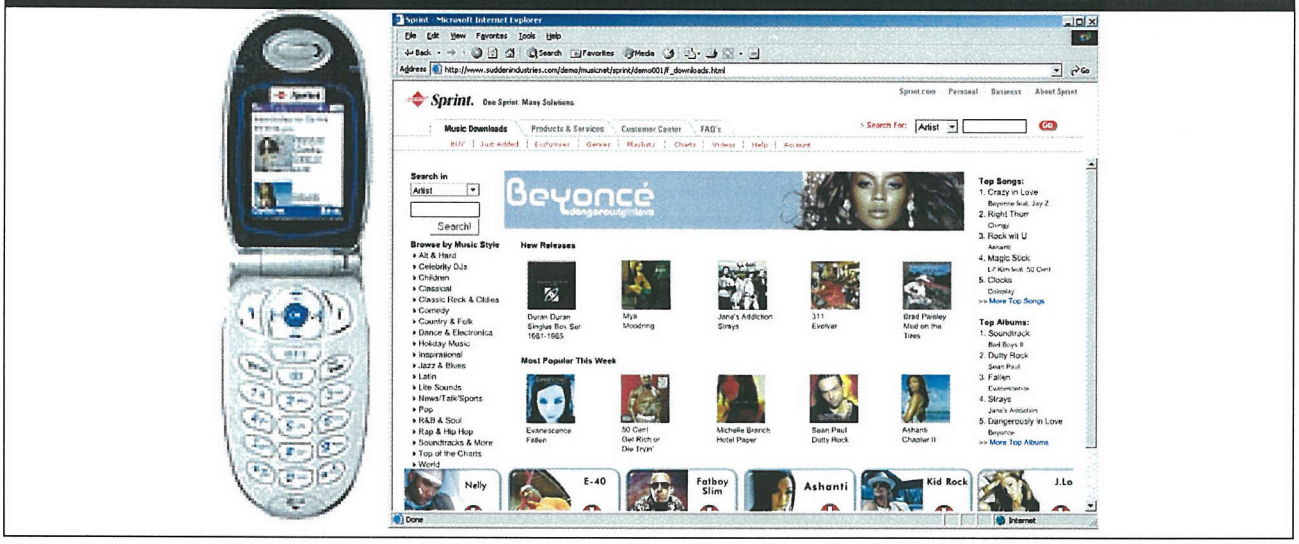


28. Additionally, MusicNet has a complete music service (called "Performer") that distributors can use if they want a turnkey user interface. It can be displayed via a web browser or within a MusicNet media jukebox player. Distribution partners can "skin" the user interface to match their brand's look and feel, and to create a customized experience. From a distribution partner's perspective, Performer shortens the time to market by significantly lowering the development time and investment required.

Performer Turnkey Interface

29. Finally, MusicNet has established the requirements for creating a wireless phone interface for listening, purchasing, and sharing digital music. This application allows consumers to browse playlists, listen to samples, and purchase songs via their mobile phone.

Wireless Client Prototype



30. MusicNet offers a complete vertical solution to distribution partners by securing content from record labels and artists; delivering the content through highly flexible and functional software; handling compensation of both technology providers and rights holders; and hosting of the service. MusicNet's platform enables distribution partners to outsource their entire digital music consumer service offering, potentially saving a distribution partner millions of dollars in annual research, development, and administrative expenses.

31. As a result, MusicNet provides a comprehensive suite of services to distributors. MusicNet will do as much or as little as needed and work with each distributor to ensure the resulting package meets their business objectives and provides value to their customers, creating a legitimate market for content owners as a result.

Scope of Services and Responsibilities	
MusicNet's Responsibilities	**Distributor's Responsibilities**
• Provide software and or user interface clients	• Marketing
• Provide partner integration and development support	• Billing*
• Provide subscriber management	• Customer Service*
• Support partner's customer service	• Media Player*
• Program / highlight content of interest to users	
• Secure label / artist rights and content	
• Clear publishing rights	
• Report and pay label royalties	
• License software and administer royalties for digital rights management	
• Encode content	
• Host content	
• Provide bandwidth	

**MusicNet can provide if requested*

32. Using MusicNet's state-of-the-art platform, distribution partners have the option of offering music to consumers in one or more of four modes: (i) streaming; (ii) subscription downloads; (iii) portable subscription downloads; and (iv) permanent downloads.

33. ***Streaming:*** Streaming allows consumers who are online to listen to either individual on-demand tracks and albums or pre-programmed playlists of tracks and albums performed in real time.

34. ***Subscription Downloads:*** Subscription downloads represent tracks that are saved on a consumer's computer hard drive and may be listened to offline. However, the subscription download library accumulates tracks only as long as a consumer's subscription remains active. Once the subscription is ended, DRM technology prevents the consumer from accessing and playing the track stored on the computer.

35. ***Portable Subscription Downloads:*** Portable subscription downloads are tracks that can be saved to a portable device and listened to without an active Internet connection. With this technology, a consumer can download all the songs that their portable device can hold for the price of a monthly subscription. Once the subscription is ended, DRM technology prevents the consumer from accessing and playing the track stored on the portable device. This includes transfers of songs that have been downloaded initially to a consumer's personal computer, and songs transferred directly to a consumer's portable device, as is in the case of MusicGremlin.

36. ***Permanent Downloads:*** Permanent downloads allow consumers to purchase tracks and maintain legal, permanent ownership of the music file. Consumers are able to transfer permanently downloaded tracks to portable devices as well as burn the tracks to disc. The DRM technology is not maintained on a burned-to-disc copy of a permanently downloaded track (*i.e.*, consumer has unlimited ability to transfer music freely).

C. AS A RESULT OF OUR INVESTMENTS, WE MAXIMIZE THE AVAILABILITY OF CREATIVE WORKS IN THE MARKETPLACE TO THE BENEFIT OF CONTENT OWNERS

37. MusicNet has focused on enabling distributors to offer the deepest and broadest possible content catalog around. *See* Catalog Growth Chart, Exhibit B. MusicNet's catalog

permits exposure for the most popular songs available on the Internet as well as lesser known, and lesser played, songs. *See, e.g.*, MusicNet Plays of Subscription Service Downloads by Retailer, week of 11/12/06, Exhibit C (demonstrating that MusicNet provides access to lesser known and lesser played songs).

III. WE FACE SIGNIFICANT HURDLES IN THE MARKETPLACE AND HAVE YET TO TURN A PROFIT OR MEET INVESTMENT EXPECTATIONS

38. [redacted]. *See* MusicNet Statements of Operations -- 2002 to 2004, Exhibit D; *see* MusicNet Statement of Operations -- 2001 Through August 2006, Exhibit E. For the most part, this is due to the very high cost of acquiring content, developing and integrating our platform with our distributors and constantly working to service our distributors so they are retained and their specific needs for their individual service offering are met. In addition, significant resources are expended in acquiring new distributors and new platforms. [redacted] *See* Statements of Convertible Preferred Stock and Stockholders' Deficit Years 2004, 2003, and 2002, Exhibit F.

A. OUR BUSINESS FACES VERY HIGH COSTS AND IS NOT YET PROFITABLE ON AN OPERATING BASIS

39. There are a number of significant costs we incur as a provider of subscription music services to distributors. [redacted] *See* MusicNet Capital Investment Analysis, Exhibit A. Our music library is the result of the many licenses that we have negotiated and entered into with music publishers and with

record labels. This process involves a great deal of staff time and effort. We have entered into agreements with all of the major record labels and hundreds of independent labels for the use of their masters (*i.e.*, the actual sound recordings) within the MusicNet service. We have also licensed the public performance rights of musical compositions from the performance rights organizations in the U.S. (*i.e.*, the American Society of Composers, Authors and Publishers (ASCAP), Broadcast Music, Inc. (BMI) and SESAC). These organizations collect royalties on behalf of their constituent music publishers who control the relevant public performance rights to the musical compositions. We pay public performance royalties to cover the full value of musical compositions used in our streaming activities.

40. MusicNet has also licensed reproduction and distribution (*i.e.*, mechanical) rights pursuant to the National Music Publishers Association (NMPA) and Recording Industry Association of America (RIAA) agreement dated October 5, 2001. Under this agreement, MusicNet has obtained mechanical licenses for the musical compositions within the subscription service, for the catalog represented by the NMPA. MusicNet has also successfully directly licensed catalogs not represented by the NMPA, such as Abkco, Bug and Wixen, and continues to proactively pursue direct license agreements within the publishing community. Mechanical royalties for the permanent downloads are generally cleared by record labels for use by MusicNet.

41. In many cases, we are required to negotiate separate agreements with the record labels for the rights to provide subscription services and the right to provide permanent downloading capabilities. Subscription rights are more complex to negotiate and manage than à la carte downloads rights. There are many more restrictions on usage rights, and the economic

structure and reporting is substantially different than for permanent downloads. MusicNet has entered into agreements with all of the major labels to offer subscription music services. MusicNet believes that its early lead in securing agreements to offer subscription service has provided it with a significant advantage.

42. Second, we spend a great deal of time and effort "ingesting" the content once we receive it from the record labels. An original work can come to MusicNet in many different raw forms, including compact discs, hard drives, and electronic files. Transforming raw content into a form that can be downloaded by consumers requires more than merely uploading the songs to MusicNet's servers. We have to convert the raw audio assets and metadata we receive from the record labels into digital copy-protected reproductions of music that can be accessed online. MusicNet also performs significant quality control procedures to ensure the quality of the musical composition. For instance, we validate the metadata, such as the artist(s), track title, album title, album and track duration, any specific notes supporting the track (for example, whether the track is a remix or has a parental advisory tag), composer, publisher, orchestra, ensemble, conductor, soloist, and instruments. MusicNet also sets the track and album level rights, plus the release and expiration dates for the content, in order to manage the usage and availability rules established by the content owners. Furthermore, MusicNet sets the wholesale, and, in the case of its own service ("Performer"), retail pricing for the content. Additionally, the audio assets are encoded in a proprietary specification for MusicNet's distribution partners, with varying bit rates for streams and downloads. The audio assets are then encrypted in a Digital Rights Management, or DRM, wrapper that controls the availability of the file under the rights determined by MusicNet's service, in conjunction with the content owners. The audio files, and

associated metadata, are then published to our output servers so that they can be made available to consumers though our various distribution partners.

43. The ingestion process is crucial for two reasons. To begin, when a consumer purchases or otherwise downloads a song, the consumer is expecting a CD-quality reproduction just as he or she would purchase through a brick-and-mortar store. Absent the lengthy quality control and coding process, the quality the consumer expects could not be guaranteed. Moreover, because of the vertical shape to MusicNet's distribution structure (*i.e.,* MusicNet provides content to distributors who then sell to consumers), MusicNet must ensure that each original work is compatible with the online hardware and software structure of each of its distributors. To date, ingesting licensed music has cost MusicNet [redacted] For instance, we spent [redacted] from 2003 though 2006 paying to receive content delivered from the content owners and employing a team to ingest and manage the content. This cost does not include, however, the equipment or warehouse space required to store content, the cost associated with negotiating or acquiring licenses to content, or any royalties payable for use of the content.

44. Finally, we incur significant costs on a range of operational fronts: the architecture of the musical platform, software, distribution integration, hosting services, and other "infrastructure" costs, including "back office" and financial services, are all required to be able to deliver a high quality services. *See* MusicNet Year-to-Date Operating Summary, August 2006, Exhibit G.

45. [redacted]

46. [redacted]

47. [redacted]

48. These financial data illustrate the importance of containing all costs and increasing the revenue base over which these costs are spread. However, increasing the revenue base requires investment in expanding content, creating new value-added content, marketing and promotion, as well as enhancing technology to maintain and attract new customers. Given our cost structure, every effort must be made to contain costs.

B. OUR INVESTORS HAVE YET TO MAKE A RETURN ON THEIR INVESTMENT

49. The precursor to MusicNet, Inc. was founded in 1999 by RealNetworks. This entity executed its . In 2001, MusicNet, Inc. was formed

[redacted]

50. [redacted]

IV. THE MUSIC MARKETPLACE IS INTENSELY COMPETITIVE AND OUR SUCCESS IS DEPENDENT ON A NUMBER OF FACTORS THAT ARE NOT IN OUR CONTROL

51. MusicNet faces several very significant challenges in the near future. First, Music sales have fallen substantially over the past five years and there is increasing speculation about the viability of the traditional record business as a result of significant piracy. According to the International Federation of the Phonographic Industry, or IFPI, "In January 2006, IFPI estimates the number of infringing music files available on the Internet at any one time -- in other words,

the simultaneous availability of copyrighted music tracks for illegal download or distribution -- at 885 million, of which 775 million are available on P2P networks and the remainder on websites." The number of pirated music files on the Internet has been reported in the hundreds of millions or nearly a billion. The majority of Internet music consumers have downloaded pirated versions of songs illegally. Despite the publicity, recording industry lawsuits have not put an end to piracy. Many consumers still believe there is nothing wrong with downloading illegal music or sharing it with their friends. Another reality is that the individuals most likely to pirate music are young students with much time and little money. In other words, the culture of piracy could lead to ever-decreasing music value on the part of consumers in the future. Our fledgling business is forced to compete in a marketplace in which our fundamental competition is the widespread availability of free product to consumers. Piracy puts tremendous downward pressure on the price at which we can offer music services for sale in the marketplace. In short, it is difficult to compete with "free" -- piracy makes it far more difficult for us and our partners to achieve profitability.

52. Second, consumers are not accustomed to purchasing music as part of a subscription service rather than owning recorded music outright. Distributors' efforts to market the subscription service will have a great effect on the long-term viability of the subscription business model. These efforts are crucial now; yet, some distributors have yet to invest heavily in the marketing of this model, in part, because their margins are small and the potential of the market has not yet been proven. Indeed, we are competing to establish our business model both in the minds of our distributors and their end consumers. To be sure, legal online music distribution is a growing business. But most of the growth has come from single track downloads and not from subscription services such as those offered by MusicNet.

53. One of the most significant obstacles to convincing consumers about the viability of the business is that there are restrictions imposed by content owners on the tracks available in the subscription service and on tracks available for purchase as permanent downloads. Some songs can be listened to on a computer, others on a portable device, others burned to CDs and put on other devices. This is confusing for users and makes it hard to convince customers of the value of services like ours. As a result, we are at a considerable disadvantage acquiring and keeping customers who can rip and burn free music from each other instead of waiting for the market to catch up to them. Additionally, the portable devices that interact with our services, both for subscription and permanent download have not yet gained mass consumer acceptance. The one portable digital music device that has gained consumer acceptance is the iPod, which Apple has made incompatible with every service other than iTunes.

54. [redacted] Our input costs are too high, from what we pay labels to what publishers demand for performance and mechanical royalties. We have to constantly invest in acquiring distributors, integrating our platform, and personalizing and customizing our service for them to keep their customers engaged. There are new features and technologies on the horizon to make it easier to find music, personalize collections, and share and experience them. All of this will require more investment and further modifications to our platform and technology. These costs will continue to increase and there is no end in sight. Meanwhile, we will continue to compete against free music in an environment where broadband access and technology make it easier and easier for consumers to bypass the market and find what they want to play and share with each other without paying for it. This is a developing market. Until the business is proven, costs need to be kept down.

V. A REASONABLE ROYALTY WOULD MINIMIZE DISRUPTION OF THIS EMERGING MARKET

55. The legal music downloading market is growing because more and more consumers are seeking comprehensive, safe, secure, and advanced methods of accessing music. MusicNet's investments are enabling a more meaningful music experience for consumers and providing value to content owners as a result. But the future is far from certain. As this market emerges from the early stages, an overly high royalty rate would effectively stunt -- if not dissolve altogether -- whatever slim incentives exist for continued investment.

56. Substantial challenges remain. Piracy shows absolutely no signs of abating. Distributors are going to need to substantially invest in marketing subscription services to consumers. And consumers are going to begin demanding increased portability and access to music across all platforms and devices. The future of portable music devices -- which is totally out of our control -- is incredibly important to our business. Consumers are getting more and more accustomed to carrying their large music collections with them. Subscription services such as those we provide through our distributors have a unique opportunity to leverage the growth of these devices to attain broader reach and scale. If these platforms are closed or difficult to access or not accepted by consumers or the costs of providing services is too high, the business will not evolve.

57. The Board should therefore take care not to impose a royalty rate in this proceeding that jeopardizes our ability to continue to grow this market. The market for legitimate digital music services is fragile enough -- especially for subscription services. Setting a royalty rate that is too high would almost assuredly signal the end of certain business models

all together. A rate that is set too high will severely disrupt the digital music marketplace and result in a loss of consumer confidence with respect to legal digital music services. As a result, there will be an increase in piracy activities.

58. The statutory mechanical rate could have a significant impact on our business because [redacted]. Therefore, we need to be able to devote as much revenue as possible to adding new distributors and providing incentives to our current distributors to expend significant resources in marketing so as to attain viable scale. A royalty rate that interferes with our ability to acquire new distribution channels, further reduces our and our distributors' margins, or impacts our ability to offer our services in new ways will likely mean the end of our business. Forcing a legitimate music service to price itself out of the market only results in more piracy activities, which harms both copyright owners and users. In addition to increasing piracy activities, forcing us to raise the fees for our services above the consumer breaking point jeopardizes our ability to compete with other forms of music entertainment, such as satellite radio. A royalty rate that is set too high would be catastrophic to our already vulnerable business model.

59. In particular, the Board should ensure that the revenue base to which the rate is applied is attributable solely to the music service purchased by consumers and does not impose a tax on other business activities. A percentage of revenue rate is an efficient way to ensure all parties in the value chain share in the risks and rewards of the endeavor, but it should not capture revenues that are not associated with the music itself. In addition, the Board should avoid the imposition of so-called "minimum fees" at this time. Any requirement that digital services pay a minima, either per subscriber or per play, would have a detrimental effect industry-wide.

Imposing any type of minima would destroy our distributors' ability to vary prices, jeopardizing their market viability. In the end, minimum fees would result in the imposition of artificial usage limits, reducing output and the generation of revenue in the market.

60. On October 6, 2006, MusicNet entered into an agreement settling copyright royalty litigation in the United Kingdom. The settlement and license are attached. *See* Settlement Agreement and License, Exhibits I. As a result, MusicNet will pay the greater of 8% of its adjusted gross revenues less VAT or applicable minimum fees to the owners of copyright in musical compositions for a blanket license to the rights that include the equivalent of the United States rights of public performance, reproduction, and distribution, as well as the right of communication to the public, which is not provided for in the United States. Certain issues relating to the definition of gross revenues or other carve-outs remain to be litigated by the parties. We believe the settlement represents a fair compromise to settle litigation in that jurisdiction. It does not provide a directly applicable analogy to the United States because of the nature of the rights conveyed and differences in the respective markets. However, it is a significant development from our perspective in recognizing the early stage of the business, the need for stable royalties, and the importance of minimizing administrative costs.

VI. CONCLUSION

61. For the foregoing reasons, I support DiMA's proposed rate of 4.1% of applicable revenues for permanent downloads and 4% of applicable revenues for limited downloads, as well as DiMA's proposed terms. DiMA's proposed rate will provide content creators and users with a fair return. In addition, DiMA's proposed rates will not cause disruption to the still-evolving

digital music market and will help spur growth and development of the business to the benefit of copyright owners, users and consumers.

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

Alan McGlade

11/27/06

Date

A

This exhibit contains restricted information that is subject to a confidentiality agreement and has been redacted from the publicly filed version

B

This exhibit contains restricted information that is subject to a confidentiality agreement and has been redacted from the publicly filed version

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This exhibit contains restricted information that is subject to a confidentiality agreement and has been redacted from the publicly filed version

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