Before the
Copyright Royalty Judges
Library of Congress
Washington, D.C.

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

The Written Direct Testimony of Timothy Quirk

DiMA Trial Ex. 8

Before the
COPYRIGHT ROYALTY BOARD
LIBRARY OF CONGRESS
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Mechanical and Digital Phonorecord Delivery Rate Adjustment Proceeding	)	**Docket No. 2006-3 CRB DPRA**

TESTIMONY OF TIMOTHY QUIRK

1. My name is Timothy Quirk, and I am currently Vice President of Music Content and Programming for RealNetworks, Inc. ("Real"). I am submitting 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. As Vice President of Music Content and Programming, I am responsible for overseeing three main areas of our digital music business: content operations, editorial programming, and label relations. I carry out these responsibilities for all of Real's music properties in the U.S. Prior to coming to Real, I was the Director of Editorial for Listen.com, the online music company that originally built the Rhapsody subscription service, and prior to that I was a music journalist and the lead singer for the band Too Much Joy, who recorded for various independent labels and Warner Music Group between 1987 and 1997. In other words, I have seen the music business from multiple perspectives over the past two decades. I graduated from Stanford University in 1986.

3. The following testimony is based on my personal knowledge, information made available to me in the course of performing my duties at Real, my experience of employment in the music industry, my experience as an artist, and my review of the documents attached as exhibits to this written testimony. 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 it is true to the best of my knowledge, information, and belief.

I. SUMMARY

4. There is little question that the digital music revolution is in full swing. Real is committed to participating in the digital revolution by offering consumers the best and most comprehensive music experience possible. We are committed not just because we want to be a financially successful enterprise, but also because we believe the value of making more music more accessible to more people extends beyond our own company, to musicians, content owners, and listeners. This is the reason we started our digital music business, and it is the reason we will do everything possible to stay in the market. At the same time, we have to be realistic about the challenges we face.

5. Consumers are becoming increasingly demanding in their search for the ultimate "wherever, whenever, however" music experience. In many respects, consumers have come to expect from digital music services what they expect from email systems - complete and ubiquitous access. The value of email is that it is not tied to a particular device or piece of software. At Real, we are committed to trying to create the same consumer appeal in a digital subscription music service. But this may not be feasible if we are saddled with increasingly unrealistic royalty costs.

6. The market for digital music subscription services is still new and constantly evolving. In the context of this uncertainty, we continue to work hard and spend money to improve our product -- all the while knowing that the music we offer is readily available elsewhere for free. Internet piracy did not die with the demise of the original Napster P2P application or the Grokster court decision. Hundreds of millions of music files are available for free online, and more are added each day. While iTunes is widely hailed as a success, the number of legal downloads sold each year is dwarfed by the number of tracks obtained via P2P networks. This fundamental reality influences everything we do. We are convinced consumers will pay for a service that offers the same benefits but is more compelling and easier to use than P2P applications, and the current popularity of our Rhapsody subscription service bears this out: we generate one billion song plays a year, and we pay content creators and owners for every single one of these plays. However, if excessive costs are imposed on our business, we may be forced to abandon the market to Internet pirates. If that happens, both consumers and content creators will suffer.

7. Trying to change the way people think about collecting, listening to, and paying for digital music carries inherent risks, which I will describe in more detail below. Given these risks, it is important that the royalty rate set in this proceeding not disrupt the already fragile market for legal digital music services that try to compete successfully with the free P2P experience. If stability and certainty can be achieved, creators of music and music subscription services will both benefit. Creators will benefit from increased exposure to consumers and incremental revenue from stable, legal music services in the market. Financial stability will

enable the services themselves to continue to offer the public what P2P has demonstrated it wants most: a music experience that lets people hear whatever they want at a moment's notice.

8. The rates set through this proceeding must respect these marketplace realities and appropriately allocate the risks involved in trying to create a compelling, legal alternative to unlicensed file trading. Subscription services can provide such an alternative, but the notion of paying for access to music, rather than owning music, is new to consumers; this attempts to change decades of attitudes about obtaining, listening to, and sharing music. There is substantial uncertainty regarding the viability of the subscription service model, especially in light of the fact that pirated music is still readily available.

II. REAL'S DIGITAL MUSIC SERVICES AND THEIR VALUE TO THE ONLINE MUSIC MARKET

9. Real has always been, and will continue to be, on the cutting edge of the digital music revolution. Real pioneered online streaming of audio and video in 1994, and now offers a variety of online music subscription services. Our ultimate goal is to make the "celestial jukebox" that pundits often describe a reality, offering customers ready access to music wherever, whenever, and however they want to hear it. Taken together, our services aim to allow our customers to experience the music they like best at will, whether they are driving their car, walking down the street, relaxing at home, or sitting in front of a computer.

10. Our services do far more than give listeners easy access to millions of songs - we provide intuitive ways to navigate through that wealth of material, and have developed numerous methods to help customers find new music that matters to them. In addition to helping customers find music they already know they love and play it instantly, our services enable

customers to easily discover music that they've never heard before. The customer's ability to find great new music that's relevant to their tastes quickly and with minimal effort is what differentiates our services from our competitors' and it is made possible by the unique search and discovery tools and editorial content we have developed. The result is that our subscribers listen to more - and more varied - music than ever before, and generate royalties for content owners by doing so.

11. Real was a pioneer in the development of technology for the transmission of digital media over the Internet. Worldwide, consumers use our media player software to play, create and manage their digital music collections, listen to Internet-based radio, and play streaming audio and video on-demand. Broadcasters, network operators, media companies and enterprises use our products and services to create and deliver digital media to PCs, mobile phones, and other consumer electronic devices. We have developed a variety of products and services to connect content providers, broadcasters, and advertisers, including our subscription businesses. It is our goal to continue to leverage our Internet media technology and our worldwide user base to increase our sales of digital media products and services, including our music business.

A. OVERVIEW OF OUR SERVICES

12. Real's current music service offerings in the U.S. include: Rhapsody 25, Rhapsody Unlimited, and Rhapsody To Go. All of our services are marketed through our family of websites, including Rhapsody.com, as well as third party distributors and devices. A video introduction to our Rhapsody service and Sansa portable device is included in the files attached hereto as Exhibit A.

13. **Rhapsody 25** is our introductory tier. It can be accessed via Rhapsody.com, or by downloading and installing our Rhapsody client software. Rhapsody 25 customers need not enter a credit card to access our vast catalog of almost 3 million tracks, expertly programmed Internet radio channels, and more. They can play up to 25 full on-demand tracks each month, plus 25 Internet radio channels in a variety of musical genres. Although we do not charge for Rhapsody 25, content owners get paid for every play. Rhapsody 25 is a great way for consumers to be introduced to the many benefits of a subscription service. It is less a stand-alone product than a promotional offering intended to lead consumers to our Rhapsody Unlimited and Rhapsody To Go services.

14. **Rhapsody Unlimited** is an on-demand digital music subscription service. Subscribers to our Rhapsody Unlimited service enjoy the ability to play any of nearly three million individual tracks and over two hundred thousand individual albums whenever they want, as often as they want, for a monthly fee of $9.99. "Unlimited" refers to the fact that there is no limit on the number of "plays" a subscriber may demand over the course of the month. Rhapsody Unlimited subscribers can also download an unlimited number of songs to their computers to enjoy regardless of whether their machine is connected to the Internet, as long as they remain subscribed to the service.

15. **Rhapsody To Go** is a premium service for subscribers who want to be able to listen to their music collection on a portable device. Subscribers to Rhapsody To Go receive all the benefits of a regular Rhapsody Unlimited subscription, as well as the ability to download an unlimited number of songs to compatible portable devices, without paying any additional charges. Subscribers are charged a monthly fee of $14.99 for the Rhapsody To Go service.

16. All three tiers of the Rhapsody service (25, Unlimited, and To Go) provide customers with far more than quick, easy, and legal access to a vast library of music. Customers can share any album, track, or playlist in our service with friends by emailing, instant messaging, or blogging "rhaplinks" that will launch those tracks for anyone who clicks on the link. Customers also gain access to Internet radio channels, music videos, playlist creation, personalized recommendations, and, most importantly, a database of award-winning editorial content and programming that both helps them learn more about what they're listening to, and points them toward additional music they're likely to enjoy. The Rhapsody desktop application also functions as a fully-featured music management system, allowing users to organize their existing music collections and integrate them with offerings from our catalog, and burn CDs of their favourite albums, tracks, or playlists. If they wish, subscribers can also purchase most of the tracks in the catalog at a discount (currently $.89/track).

17. Three of the features mentioned above are worth describing in more detail, as they embody Rhapsody's mission to give more people a way to listen to more music more often, legally. One unique navigation feature is Rhapsody's style tree, which classifies all the music in our catalog into over 500 distinct musical genres (Rock/Pop, for instance, has 18 different sub-genres, including Metal, which in turn breaks down into a dozen unique subgenres, from Black Metal to Speed Metal). This genre tree helps customers pinpoint the precise type of music they enjoy, and discover new music based on those tastes. Every genre in our style tree comes with a description of the sound and history of the style, as well as lists of the key artists, albums, and tracks that define that particular musical style. These features encourage extensive musical

exploration and help educate listeners about styles of music they may have heard about, but never before had a chance to actually hear.

18. Second, when customers want to hear some music, but don't have the time or inclination to go browsing through our catalog, Rhapsody's commercial-free Internet radio channels provide the means to "just hit play," lean back, and get fed a constant supply of enjoyable music. Rhapsody offers over 100 "pre-programmed" channels in a variety of musical genres (everything from early classical to the latest electronic music). These channels are programmed by our in-house music experts, and can play for hours (sometimes days) without repeating a track. In addition, every artist in our system (there are currently over 100,000) is linked to its own "artist channel," that will play music by that artist and other artists we think fans of that artist will also enjoy.

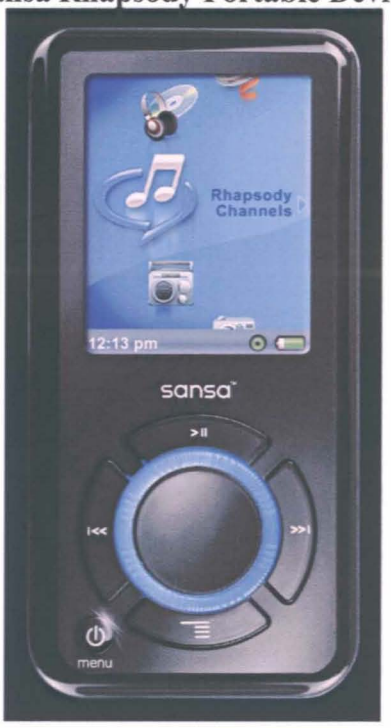
19. The third unique feature is called "Dynamic Playlists." These are essentially music feeds that update with new tracks on a regular basis. If you're a hip-hop fan, for instance, you can sign up for our Hip-Hop Burners dynamic playlist, and every Tuesday you'll get a new batch of the latest rap and hip-hop releases. All our channels and dynamic playlists can be transferred to the Sansa Rhapsody, a portable device optimized to work with Rhapsody's To Go service that we've developed in conjunction with SanDisk, giving Rhapsody To Go subscribers a way to listen to whatever they want, whenever they want, wherever they want. Whenever those customers reconnect their device to Rhapsody, we update their channels and playlists with new tracks.

20. The **RealPlayer Music Store**, available on the Internet through our RealPlayer product, enables customers to purchase individual digital music tracks without subscribing to one of our subscription services. The RealPlayer Music Store has over 2.5 million songs available for purchase. Individual tracks typically sell for $.99, and albums typically sell for $9.99.

21. All of the work that we put into creating and running our digital music services has the very simple goal of making as much music as possible available to the largest audience possible. The core features of our services are: 1) access to a vast music catalog; 2) intuitive, engaging ways to navigate through that catalog; and 3) programming and personalization that make it easy to find music users love and music they don't yet know they love.

22. While most of the individual product offerings described above require a PC for access, our ultimate goal is to make Rhapsody "platform agnostic." In order to be a true celestial jukebox, the Rhapsody service needs to be accessible anywhere our customers find themselves: not just at their computers, but in their living rooms, in their cars, at the beach, on airplanes, and on trains. Thus, Real has been working to create a seamless digital music platform. We refer to this project as "Rhapsody DNA," and its intention is to give customers the ability to connect to their Rhapsody account from any of a number of different devices. The Rhapsody.com website, for instance, allows customers to access their account from any web browser (and provides Mac users with a way to enjoy Rhapsody). The Sansa Rhapsody portable device helps customers take Rhapsody's rich music discovery features with them in their pocket.

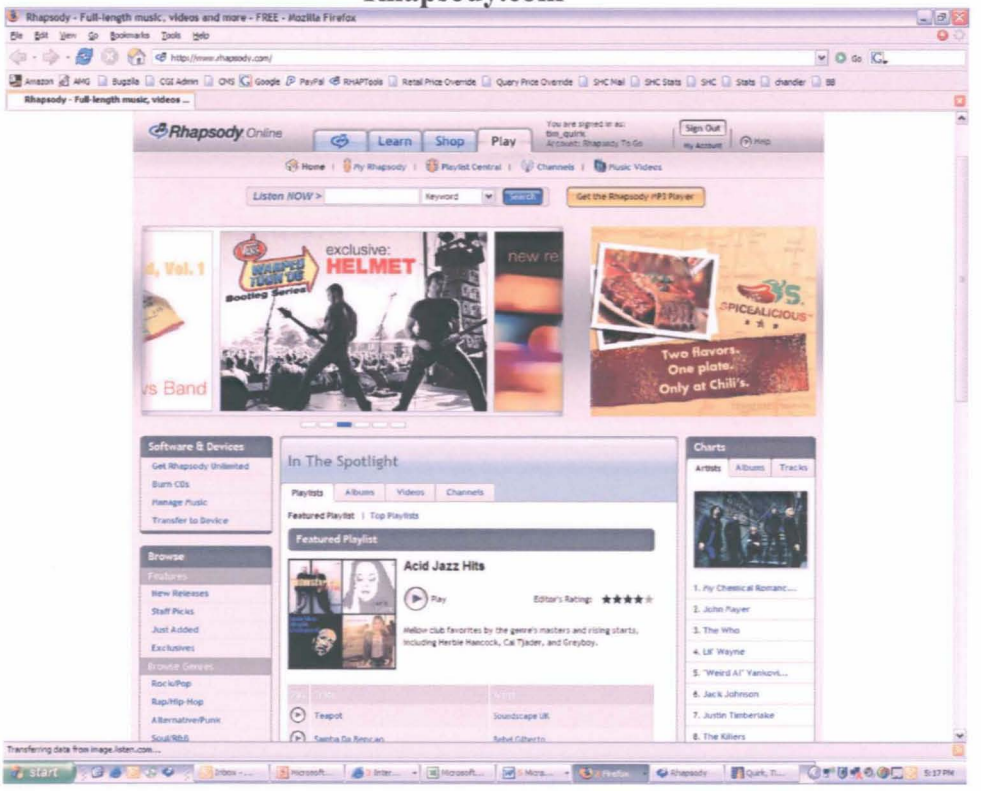
Sansa Rhapsody Portable Device



And we've recently partnered with Sonos to create home stereo components that connect directly to Rhapsody's servers – now customers can browse Rhapsody's vast catalog from the comfort of their couch, and play anything they want through their stereo. Our Rhapsody DNA project is certainly ambitious (and costly, both in terms of resources and in terms of the financial investment), but we believe it will redefine the digital music experience by creating ubiquitous, personalized and interoperable music access from any device.

23. A consumer's first interaction with our services is often through our Rhapsody.com webpage.

Rhapsody.com



24. As with anything new, one of our biggest challenges is convincing consumers to give our service a try, so we are constantly experimenting with ways to introduce new customers to our services. In addition to the free Rhapsody 25 offering, we have created strategic partnerships with retailers and device manufacturers to increase Rhapsody's exposure to consumers. For example, we have a relationship with Best Buy, the nation's largest electronics retailer, for the co-branding of our Rhapsody service. Customers who sign up for Best Buy's Digital Music Store are actually receiving a version of our Rhapsody service. The Best Buy service is sold in a retail outlet, away from the PC-centric environment, allowing us to reach a broader spectrum of consumers. Best Buy also sells the Sansa Rhapsody device. When a consumer purchases a SanDisk portable device, they receive a free trial subscription to our Rhapsody service. In return, we pay a "finder's fee" to SanDisk for helping us sign up those

subscribers. We spend a great deal of time, money, and effort to develop and utilize these third party relationships because they are important to our overall marketing efforts to get the word out about our service.

B. FULFILLING CONSUMERS' DEMANDS FOR A COMPLETE DIGITAL MUSIC EXPERIENCE

25. At Real, we understand that a successful digital music service must provide more than just lots of songs. When we first built Rhapsody, we recognized that, for all the hoopla surrounding the original Napster, it had essentially been a tool for finding music you already knew about. We strove to make Rhapsody much more: not just a tool, but a complete music experience. We don't just offer access to music. We also help put your music into a broader context, and we provide novel ways to identify and organize the artists, albums, and tracks that you like most; paths that lead from the music you like to new music you wouldn't otherwise have discovered; and a community of like-minded music fans with whom you can share your discoveries. All of this requires resources, creativity, and hard work on our part.

26. The "celestial jukebox" experience that we offer our users starts with giving them access to the most comprehensive music catalog possible. We currently have 2.9 million tracks available for on-demand streaming and To Go use, of which 2.5 million are also available for permanent download or purchase. By the end of 2006, our catalog will contain over 3 million individual tracks. Our catalog also contains over two hundred thousand albums, representing a wide variety of record labels and musical genres. The chart below shows how our catalog has grown since we first began our subscription service:

Table 1 - Historical Catalog Growth

Year	Total Tracks Encoded In Catalog	Percentage Increase Per Year
2001	48,000	N/A
2002	200,000	316%
2003	400,000	100%
2004	1,047,330	162%
2005	1,794,219	71%
2006	3,357,087 (projected)	87%

It is crucial that our "celestial jukebox" give users access to the largest catalog possible, and that the catalog reflect the incredible diversity of recorded music today. Our catalog includes artists from a wide spectrum of record labels, including a huge collection of independent artists and titles that had fallen out of print. Because our "shelf space" is virtual, we can stock music that is simply not available at physical retail stores such as Wal-Mart or Tower Records. We give many independent artists access to a consumer market that would otherwise be completely unavailable to them. And because all it costs one of our customers to listen to something new is time, this diverse array of music is finding an audience.

27. Rhapsody enables music discovery at a level that is unmatched elsewhere in the music business. According to market research I am familiar with in my duties at Real, 48.5% of sales at a physical retailer such as Wal-Mart is generated by the top 100 artists. At online retail outlets such as iTunes, where the selection is larger and the price is effectively far lower because users can purchase individual tracks rather than complete albums, the percentage of total sales attributable to the top 100 artists drops to 33%. On P2P services, where the selection is nearly

limitless and the price is zero, the percentage of activity attributable to the top 100 artists drops further, to 28%. Because Rhapsody makes it even easier for customers to navigate through a massive catalogue of music, we beat even P2P networks for music discovery. In an average month, about 24% of our total plays are attributable to the top 100 artists. A summary of these findings is included in the presentation "Subscription Services: Why Should You Give A Damn?," attached hereto as Exhibit B. In other words, we beat both large retailers and illegal file sharing services for effective discovery of lesser known artists. Of course, these artists benefit in turn from wider exposure to the consumer market, and earn money from every single play they receive through Rhapsody.

28. Unlike physical retail shoppers or users of illegal file sharing programs, our customers can read editorial features written by our expert editorial staff about the artists and music we offer. These features include artist biographies, album reviews, and "track facts" that appear in our player window while a particular song is playing. We invest heavily in this unique editorial content, because we believe it adds significant value to our services in the eyes of consumers, many of whom are interested in learning more about the music they already like as well as obtaining information about artists and genres with which they're not yet familiar.

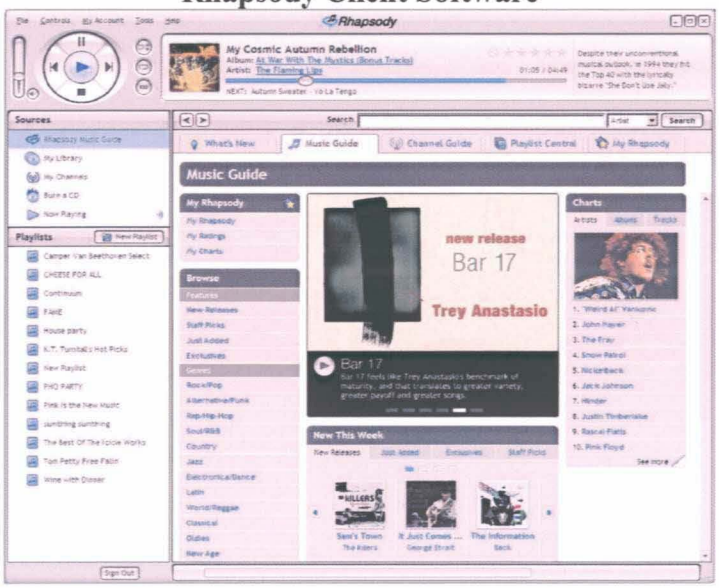
29. Our editorial staff does far more than simply write, however. Indeed, the bulk of their work revolves around assigning proprietary "metadata" to artists, such as styles, similar artists, and key tracks. This data powers many of our personalization and recommendation features, which help expose relevant parts of our catalog to our customers, based on what they've listened to so far. We have two types of recommendation features in Rhapsody. "Passive recommendation" features, such as the "albums for you" module or "my dynamic playlist,"

automatically suggest albums and tracks we think a customer will enjoy, based on the tracks they've played most recently. These modules update regularly, with no action required on the customer's part. "Active recommendation" features such as our "Custom Channels" require customers to provide us with specific information about artists they like in order to receive recommendations. Developing, maintaining, and enhancing these features is costly and time-consuming.

30. We further personalize our users' music experience by offering a rating system. Customers can rate any artist, album, or track in our service on a scale of "don't like" to 1 to 5 stars. These ratings help us further refine which new tracks, artists, playlists and channels we think particular users might enjoy. The rating system encourages our users to explore more music and develop their musical likes and dislikes.

31. In addition to the robust catalog and our unique editorial content, our software's ease of use is also critical to the appeal of our services. The more intuitively our services work, the more likely users are to explore the catalog and get hooked on all that Rhapsody has to offer. To encourage that exploration, we have designed the most user-friendly interface we can. The screen shot below provides a taste of our client software, which helps make music exploration as user-friendly as possible.

Rhapsody Client Software



32. Our services' comprehensive search and browsing capabilities work in tandem to help users get more out of the subscription service. We can put as much music in our catalog as possible, but if subscribers cannot easily find what they are looking for, the service loses value for them. Users who know exactly what they are looking for can find it quickly by searching for specific artists, track or album names, or composers. Our services' browsing functionality, on the other hand, opens up myriad possibilities for users who want to explore the catalog and search for music they didn't necessarily know they were interested in when they signed up. We try to ensure there are no dead-ends in the catalog: each artist and album page should lead to other similar artists and other similar albums. Simply by clicking one link after another, subscribers can spend hours exploring our catalog and experience a choose-your-own music adventure.

33. Here is how such an adventure might play out. A customer might start by searching for a current hit, such as Gnarls Barkley's "Crazy." A quick glance at the artist's biography reveals that Gnarls Barkley is not a person but a duo consisting of producer Danger Mouse and singer/rapper Cee-Lo. A convenient link leads to Cee-Lo's solo work. Now listening to Cee-Lo's greatest hits albums, our customer might peruse playlists featuring Cee-Lo tracks created by other Rhapsody subscribers, such as one titled "Sunday Morning Cleaning" by username "avenue." This user recommends Duke Ellington and Fela Kuti for people who like Cee-Lo, so perhaps our customer decides to give the big band leader a try, and clicks on the Duke Ellington link. But Duke Ellington has dozens of albums on his artist page, so where to start? No worries, our Jazz editor has provided an "artist sampler" of key Duke Ellington tracks to introduce the customer to his work that starts with "Satin Doll" and ends with "In a Sentimental Mood." If our customer enjoys this, he or she might dig deeper into Duke Ellington's albums, or else choose to read more about Big Band music. Our Big Band genre page provides multiple paths to explore -- key albums from Woody Herman and Count Basie, lists of other key artists, and more. Our customer might find that many hours of musical exploration have now gone by, when all he thought he wanted was to hear the chart-topping hit, "Crazy." This level of exploration leads to greater consumption of music, which is very much to the benefit of songwriters.

34. We also allow our subscribers to create and experience their own playlists, in several different ways. Traditional, static playlists can be created when a user or editor specifies a sequence of tracks and chooses to publish them in our "Playlist Central" section, where they can be browsed and rated by other customers. Dynamic playlists update regularly. Some, such

as "Rhapsody Recommends" and "Hot Rock," are manually programmed by our editors; others, such as "My Dynamic Playlist," are adjusted automatically based on a user's listening patterns. Subscribers to Rhapsody To Go can transfer playlists to a portable device, and subscribers using the Rhapsody-optimized player manufactured by SanDisk can choose to have the dynamic playlists on their devices updated every time they connect to a computer. Subscribers can also share their playlists with other subscribers.

35. All of the special features and functionality included in our services benefit the content creators whose music appears in our catalog because it makes their music easier for consumers to find. We don't just put music on a virtual shelf. Instead, we give consumers the tools they need in order to find, listen to, evaluate, and collect the music they like. As subscribers use our browsing features, they are constantly exposed to music and artists they've never heard of before, or have heard of without ever actually hearing. As the percentages of sales/plays generated outside of the top 100 artists in different environments attest, once people subscribe to our service, they listen to more music and a wider variety of music than ever before. The charts below demonstrate how our service exposes more music to our subscribers. The charts show that while the top ranked conditional play tracks receive a high number of plays, the lower ranked tracks still get played as our users explore deeper and deeper into our catalog.

Table 2

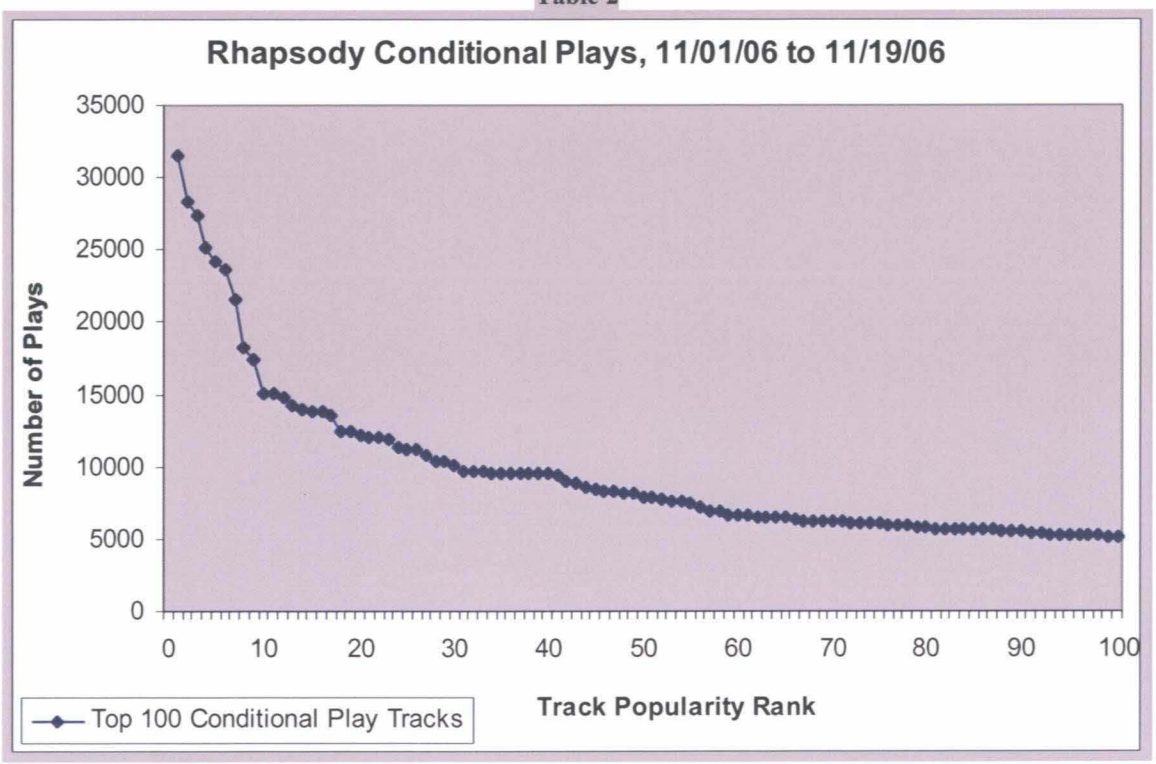


Table 3

I believe, based on my experience in the music industry, that this level of exposure for the lesser-known tracks cannot be matched by a traditional music retailer. More information regarding the usage of our catalog across musical genres can be found in the chart attached hereto as Exhibit C.

36. Digital music subscription services like Rhapsody provide much, much more than the music itself. No collection of physical music recordings, no matter how large or diverse, can be enjoyed the way Rhapsody can. Unless a consumer happens to live near a physical retail store that employs the friendliest and most knowledgeable clerks in the world, he or she will never have access to the kind of recommendations and reviews that Rhapsody provides with the click of a mouse. As a result, Rhapsody subscribers are in a much better position than the traditional purchaser to find the music they are looking for, whether they know they are looking for it or not. Once users have found music they like, they can enjoy and manipulate it in ways the purchaser cannot, whether they choose to integrate their subscription library with their existing collection, build and share their own playlists, or simply browse the endless possibilities of the Rhapsody catalog. Every user wants to enjoy music in his or her own way, and we believe that our subscription music services provide more, easier to use options for those users than any other type of product.

III. THE MARKET FOR DIGITAL MUSIC SUBSCRIPTION SERVICES IS STILL NEW AND HIGHLY COMPETITIVE, AND IT MUST OVERCOME THE UBIQUITITY OF ILLEGAL SERVICES

37. We believe that Rhapsody is an incredibly compelling service, and our product reviews support this view. However, we face a big challenge convincing customers to try our service, because paying for *access* to music rather than for *ownership* of music requires a major mental shift. Subscription services are often dismissed as "music rental" services. We do not

believe this is a fair or accurate description of the service we provide, but it is the prevailing myth we must contend with. Disproving this myth is no small task.

A. THE CHALLENGE OF CHANGING WELL-ESTABLISHED CONSUMER ATTITUDES

38. It is our goal at Real to change the way people think about consuming music. We want consumers to think of music as a service instead of a product – less like a good you rent for a limited time from Blockbuster and then return, but something more like electricity: a utility for which you pay a monthly fee, knowing that it is always "there" when and where you need or want it.

39. We devote significant resources to educating consumers on the unique benefits offered by a subscription music service. But it is very difficult to change consumer attitudes about subscription services because the majority of digital music users are still more comfortable with the a la carte permanent download model. A subscription service takes the risk out of getting new music because we offer almost unlimited opportunities for customers to try before they buy. Unlike traditional purchasers, our subscribers never experience buyer's remorse after paying for a song or album they eventually discover they do not like.

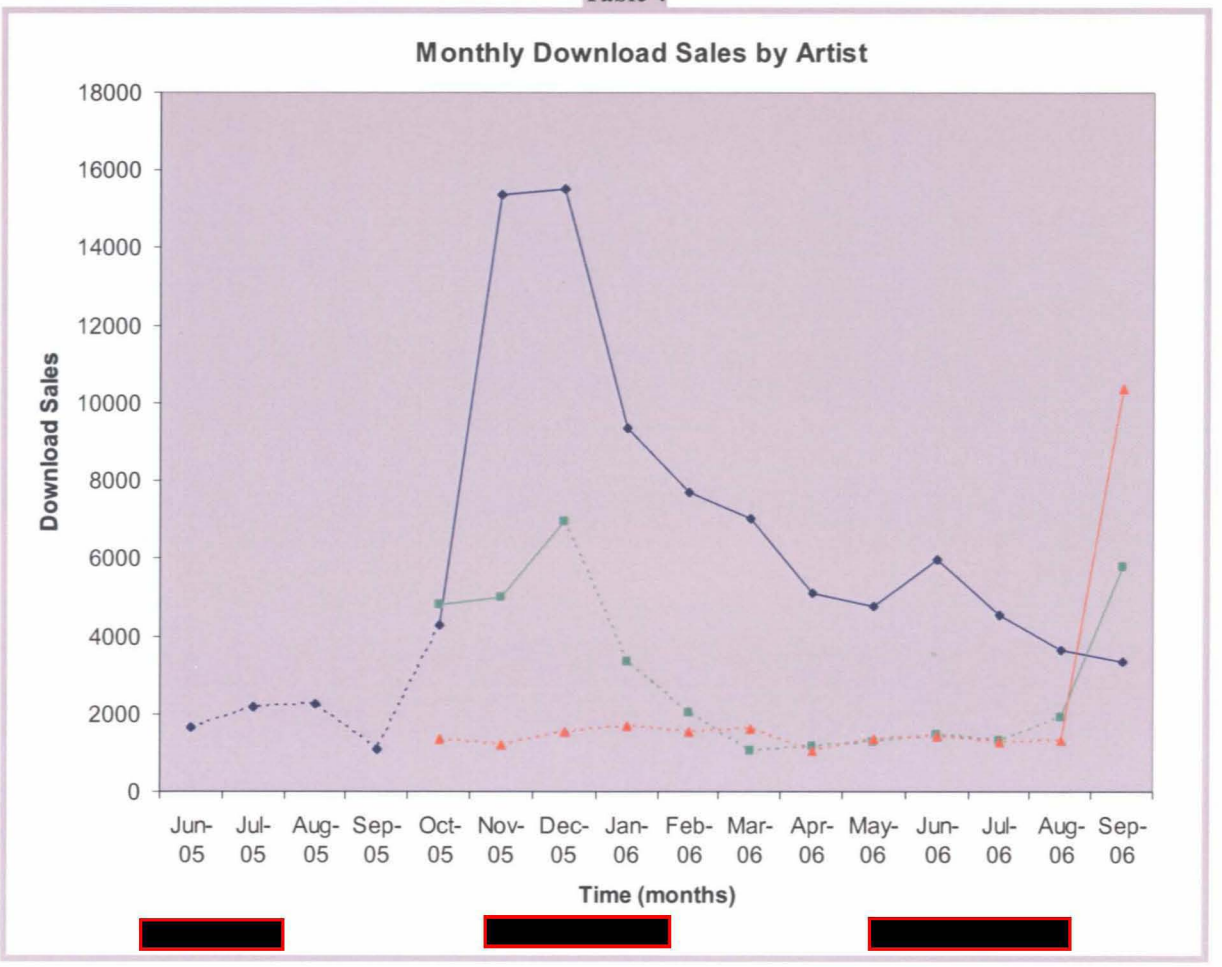
40. We work hard just to get consumers to try our service. Today, we use our free Rhapsody 25 offering as one of the primary means to introduce consumers to our services. Rhapsody 25 allows anyone who accesses our website through the Internet to play music for free. Of course, we pay royalties to music copyright owners for all our streaming activities, regardless of whether we charge our customers for a particular use. Educating consumers about the benefits of a subscription music service is a substantial cost for our business.

41. Consumers are not the only people we must educate about our service. We must also convince content creators and rights holders that a subscription service model benefits them immensely. Some copyright owners fear that offering music through unlimited on-demand streaming cannibalizes permanent download sales and physical retail sales. This is categorically not the case. A recent study found that of online adults who expressed an interest in an unlimited subscription service, 44% said they would also be interested in downloading individual tracks for $0.99. On the other hand, the percentage of overall online adults who said they would pay $0.99 for individual music tracks was only 16%. We see that interest in a subscription service does not reduce interest in purchasing individual songs. To the contrary, interest in subscription services is associated with more purchases.

42. Our own experience has shown that the availability of an artist's work to be played on-demand within our subscription service drives more purchases of that same music. A detailed exploration of this relationship can be found in the presentation "Saddle Creek Records," attached hereto as Exhibit D. When an artist's tracks that were once available only for purchase suddenly become available for on-demand listening, that artist's download sales dramatically increase. We have seen such increases by a factor of 2X up to 10X. For example, we observed that [redacted] was selling less than 2,000 tracks a month before we obtained on-demand playback rights to her music. Track sales doubled when we were able to make her music available for subscription playbacks, and when she released a new album, track sales tripled. A year after we began offering Madonna's music for on-demand playback, her track sales have finally levelled off, but at a rate that is twice as high as it was when her music was only available for purchase and permanent download. The chart below summarizes our findings

for Madonna and two other artists, Linkin Park and Janet Jackson. The dashed lines indicate the time range when subscription playback rights were not turned on. The solid lines show that availability of on-demand playback enhances permanent sales.

Table 4



[redacted] [redacted] [redacted]

We have also seen that 60% of our permanent downloaders are not impulse buyers - they purchase after listening to a track an average of five times. Making works available through a subscription service allows users to experience new music without risking buyer's remorse, ultimately leading to more sales.

43. Consumers are beginning to move from physical to digital music collecting. It was recently reported that global digital music sales for the first half of 2006 outpaced digital music sales for the same period in 2005 by 106%. But we have yet to see a significant movement towards using subscription services instead of a la carte download services. A recent study found that only 32% of adults expressed interest in a subscription music service. While we are making some headway in our efforts to change consumer attitudes about subscription services, many consumers continue to resist a wholesale change in behavior. Setting aside unlicensed P2P music acquisition, the most popular way consumers obtain digital music files is still by importing their physical CD collections. We still have a lot of work to do to convince consumers that the subscription service business model offers a better way to experience the all-you-can-eat smorgasbord they are currently getting for free via unlicensed P2P file sharing.

B. OUR SERVICES FACE COMPETITION FROM ALL DIRECTIONS

44. The fact that we have created the most comprehensive, most user-friendly subscription service we can and are investing heavily to educate consumers does nothing to change the reality that consumers can find most of the music that we offer elsewhere for free. Hundreds of millions of unlicensed music files are readily available on file sharing services. When consumers obtain music illegally, artists and copyright holders suffer along with us. The huge market for pirated digital music is the single biggest challenge faced by legitimate services like ours. In the end, the only thing that we can do to fight music piracy is to offer the best service possible.

45. It is very difficult to operate and make strategic decisions in a market where our product is readily available for free. For example, we must be especially careful not to allow our

prices to rise too high. Piracy keeps our prices low because subscribers know they can get music illegally without paying a dime. We charge subscribers $14.99 per month for our Rhapsody To Go service. At one time, we considered raising the monthly fee to $16.99 per month, but we quickly realized that consumers would reject that price. The widespread availability of pirated music makes it easy for our subscribers to walk away from our services, and the wrong price is a great excuse for many of them to do so.

46. If the royalty rate set through this proceeding is too high or we are forced to pay minimum fees, it would seriously cripple the industry's efforts to fight pirated music. Any increase in costs, or any reduction in our ability to price competitively, will only make it harder to compete. There is a price above which our subscribers will decide to obtain their music from illegal sites that don't pay royalties to anyone. This constant threat looms in the background of almost every decision we make, from pricing to making changes in the functionality of our services.

47. In addition to the competitive pressures created by the readily accessible market for pirated music, we face stiff competition from other legitimate digital music services. Digital music collectors can obtain and manage their collections through a number of competing services, including Napster, Apple's iTunes Store, Yahoo! Unlimited, MTV Urge, and AOL Music Now. But our competition is not limited to other digital music services. We also compete with large box retailers such as Wal-Mart, online retailers such as Amazon, satellite radio providers like Sirius and XM, and mobile telephone providers such as Sprint and Verizon.

IV. REAL'S COMMITMENT TO THE DIGITAL MUSIC MARKETPLACE REMAINS STRONG, DESPITE ECONOMIC LOSSES, AND HAS MADE MUSIC AVAILABLE TO MORE PEOPLE

48. Real has made multi-million dollar investments in developing the technology, infrastructure, digital rights management ("DRM"), and marketing and operations infrastructure necessary to provide a compelling digital music service. These investments are very risky, as subscription music services represent a new and unproven business model. In addition, convincing consumers to adapt to new technologies and to embrace this new form of music consumption provides a significant challenge, with the inherent risk of substantial losses if there is insufficient consumer demand or acceptance. While Real acquired Listen.com, the company that first developed Rhapsody, for roughly 30 million dollars, Listen.com itself had spent more than that amount bringing Rhapsody to market, and Real has continued to invest tens of millions of dollars a year running its music business.

49. There is a general misconception that delivering music digitally is cheap. On an annual basis, our operating costs are [redacted] We incur substantial ongoing maintenance and operating costs in hosting and delivering our services. We also incur significant costs relating to licensing, research and development, marketing, bandwidth expenses, and general business management and administration overheads. These costs are outlined below:

a. Licensing costs. We spend approximately [redacted] year on content acquisition in the form of royalties for publishing and sound recordings. We also pay public performance royalties to ASCAP, BMI,

and SESAC exceeding [redacted] annually for our Rhapsody Unlimited and Rhapsody To Go services.

b. Marketing costs. In addition to costs associated with marketing our services either directly to the public or through third party distributors, we incur promotional marketing expenses. We also incur special marketing expenses associated with our efforts to change consumers' concepts of music ownership. Each year we spend over [redacted] on marketing our digital services.

c. Subscription management costs. Operating a subscription music service brings with it unique administrative costs. In addition to simply maintaining a subscription count, we must also continuously verify subscribers' credit cards to ensure that they can pay their fees. Subscribers often change the credit card associated with their accounts, or a credit card expires. Maintaining a functional credit card billing and collections system is the most important administrative function that we perform. Each year, we pay approximately [redacted] in credit card fees.

d. IT costs. There are significant technology costs associated with operating a digital subscription service. The amount of technology and infrastructure needed to provide a fast, secure, and reliable music service is staggering. Last year. we spent over [redacted] on bandwidth

costs alone. In addition to obtaining the necessary technology to run our current operations, we are always spending resources to stay ahead of the technology curve and prepare to react competitively to industry trends.

e. DRM upgrades and integration. Before they will agree to make their music available in a service such as ours, content owners insist that we protect their music with Digital Rights Management systems. But to have maximum appeal to consumers, our services must be as compatible with the wide variety of consumer listening platforms as possible. As a result, we incur substantial expenses for the creation and implementation of a comprehensive digital rights management solution that will work on as many different platforms and devices as possible.

f. General management and administrative costs. We have nearly 200 employees devoted to our digital music services. In addition to salaries and human resource expenses, we maintain offices and other facilities needed to run our music services.

50. Content acquisition is another difficult and costly challenge. Managing a catalog of millions of tracks is a very complex enterprise, requiring separate permissions from both the sound recording owner (typically a record label) and the owner of the composition on that sound recording (typically a music publisher). We need both parties to agree to each of a number of different uses of their content (on demand streaming, a la carte download, burning to CD, subscription download to a computer, subscription download to a portable device). With a

catalog of almost 3 million tracks, five label rights per track, five publisher rights per track, five media formats per track, and up to two-hundred label data points per track, there are over one billion data points involved in the ingestion and management of our content. We have a staff of twelve employees devoted to the management of this data, and it costs us over [redacted] dollars a year to manage rights content.

51. Acquiring and managing both the content itself and the associated rights is amazingly complex and administratively cumbersome, and these difficulties are hurting our business, as subscribers react negatively when it isn't perfectly clear what rights they have to use which tracks, or why. We currently have over 2.9 million tracks in our catalog that can be played back on-demand, while 2.5 million tracks are available for permanent download or purchase. In other words, not all tracks in our catalog are available for the same types of delivery to customers, and even worse, some tracks may be available for on-demand playback one week and unavailable the next, due to licensing errors or changes of ownership of the sound recording or publishing rights. This leads to customer confusion and hurts our business. Because the process is so complex and we know that complexity ultimately leads to confusion for consumers trying to navigate the various use scenarios, we have recently undertaken a rights normalization effort. We have simplified our internal rights management to avoid consumer confusion and backlash by dividing our catalog into two groups: songs available for subscription service offerings (on-demand stream, tethered download, and portable download) and songs available for permanent purchase. Of course, we'd prefer to have all of our music available for all forms of delivery, but the current complexities involved in content acquisition and ingestion prevent us from doing this.

52. We have invested much time, money, and energy in automating content delivery to help publish as many tracks as possible as quickly as we can (in a typical week, we make available up to 50,000 new tracks). However, these automated content feeds are often incomplete and change with little or no warning, requiring intensive manual processing.

53. A summary financial statement is attached here to as Exhibit E.

V. THE ROYALTY SET BY THIS BOARD MUST MINIMIZE DISRUPTION TO A RISKY, EVOLVING MARKETPLACE AND APPROPRIATELY BALANCE MARKET RISKS

54. We must constantly adjust to the demands of our market. Consumer expectations continue to rise. As a result, we are constantly evaluating changes to our business model, focusing marketing efforts on particular segments of the population, creating incentives to attract customers, and continuing to try to convince consumers that music subscription services offer an entirely new and better way to experience and enjoy music and that Rhapsody is the best subscription service available. It is important that our ability to think creatively and adapt our business model to meet market demands not be hampered by unreasonable costs associated with making content available. In addition to our need to avoid unreasonable costs, the future holds other risks for our business.

55. The success of our services depends, in part, on interoperability with our customers' playback equipment. In order to grow our music service, we must design services that interoperate effectively with a variety of consumer products, including home stereos, car stereos, portable listening devices, mobile handsets, and PCs. We are doing this through our Rhapsody DNA efforts described above. As a result, we rely heavily on significant cooperation

with the manufacturers of these various products. Thus we face a risk that if such cooperation does not materialize, our ability to offer a compelling service will be materially impaired.

56. Operating within an unsettled content acquisition environment is also a substantial risk to our business. We know how vital it is to our business to be able to acquire the most compelling content, properly ingest that content into our catalog, and make the content accessible to consumers. But with so much uncertainty regarding the availability of music for a given distribution method, consumers will likely become increasingly frustrated with our inability to offer the same catalog for all methods of acquisition. Consumer frustration may lead to an increase in illegal activity.

57. We have seen that there is price for our service above which consumers are not willing to pay. As it is now, we are all but handcuffed in our ability to price creatively to attract subscribers. There is the very real risk that if the rate that is set through this proceeding does not reflect this restriction on our business, we will be severely harmed. We must be able to retain the flexibility in our business model and our pricing structure in order to be successful and continue to offer a legal way for consumers to fully explore the world of digital music.

58. Our business operates within an overly complex and unnecessarily cumbersome licensing regime. In the U.S., the mechanical royalties owed for the sale of permanent downloads are generally included in the price that we pay to the record label who licenses the sound recording embodying that composition, and the record label pays the applicable publisher on our behalf. Conversely, we have a direct agreement with the Harry Fox Agency ("HFA") authorizing us to make reproductions of compositions owned by HFA-represented publishers as

required within our subscription service. However, our agreement with HFA does not include a royalty rate for these reproductions. Instead, the agreement requires us to pay interim advances against a statutory rate set by this Board. Under the terms of our agreement with HFA, advance payments of [redacted] and approximately [redacted] subsequently monthly payments have been made. We also pay all sound recording rights directly to the record labels who own the copyright in the sound recording. Royalty payments take up the bulk of our product margins.

59. We also pay performance rights to the three performance rights organizations representing publishers and composers: ASCAP, BMI, and SESAC. We currently have license agreements with BMI and SESAC. Under these agreements, we pay performance royalties for streams only. However, some performance rights organizations have taken the position that a performance royalty is due for tethered and permanent downloads. For example, while we do not currently pay BMI a royalty for downloads of any type, the result has been that we are forced to pay performance fees for on-demand streams that are artificially high to compensate for their perceived loss of royalties related to downloads. Until there is more legal certainty, the performance rights organizations will continue to extract more from subscription services. We have been unable to reach agreement with ASCAP regarding rates and are making advance payments pending a determination by a rate court.

60. It is vital that the royalty rate set through this proceeding accurately reflect the relationships within the market. Risks must be appropriately allocated among the content creators and the services that make the music available for consumption by the public. A percentage of revenue model would give us the flexibility to experiment with our consumer offering while guaranteeing content owners a fair share of the proceeds as the market stabilizes.

61. Furthermore, the rate for permanent downloads should be set lower than the rate for physical recordings in recognition of the investments involved in opening this new market and the benefits provided to copyright owners as a result. And because the subscription service business model is still evolving but faces several unique and different hurdles compared to the sale of permanent downloads, the rate for conditional downloads should be set at a rate lower than the rate for permanent downloads, so as to encourage development of this business. Under any licensing regime, if Real provides services through a third-party distributor, Real should be deemed the licensee.

62. There is no basis under current and projected economic conditions to require a "minimum fee" based on music usage. Any requirement that digital services pay a minimum, either per subscriber or per play, would have a detrimental effect industry-wide. Imposing any type of minimum fee would destroy our ability to vary prices as necessary to ensure fair compensation for our services. In addition, imposing minima on subscription services would force us to impose artificial usage limits on users. For example, a per play minimum fee could force us to limit the number of times a subscriber can listen to a tethered download in a given month, severely restricting our users' ability to take advantage of our vast catalog, and destroying the most attractive qualities of our service. We should not be forced to disappoint our subscribers in this way. In fact, this type of business model has been tested in the past, and it was flatly rejected by the market: when Rhapsody launched at the end of 2001, it offered an all-you-can-eat model with a flat monthly payment. Our two main competitors, pressplay and MusicNet, launched with metered usage, in which subscribers could only hear a maximum

number of plays in a given month. Our model attracted the most subscribers, and the competition quickly dropped metered usage.

63. Any increase in the royalty rates we pay for musical works would have a significant adverse impact on Real's commercial viability. If the costs of content acquisition were to increase too rapidly, we would likely have to raise the price of our services. As a result, we would anticipate a spike in our churn rate. Customers who leave our service would look to other sources for their music and many would turn (or return) to piracy.

64. The market for legitimate digital music services is already fragile. Setting a royalty rate that is too high would spell the end of our business model. An excessive rate would severely disrupt the digital music marketplace and result in a fatal loss of consumer confidence. As a result, there would be an increase in piracy activities. When the piracy market outperforms the legitimate music market, the whole industry suffers.

VII. CONCLUSION

65. For the foregoing reasons, I support a royalty rate of 4.1% of applicable revenues for permanent downloads and 4% of applicable revenues for conditional downloads and terms as set forth in the DiMA Written Direct Statement.

66. The rate proposal offered by DiMA affords a fair return for both copyright owners and users. It avoids causing disruption to the current digital music market and will result in growth and development of the industry that will benefit copyright owners, music services, and consumers.

67. Finally, the proposal will help in the music industry's fight against piracy by giving legal services much-needed stability in the areas of content acquisition and rights management.

ACTIVE 4012859v.1

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

Timothy Quirk

11/17/06

Date

A

B

Subscription Services: Why Should You Give A Damn?

Subscription Services Today: Promotion That Pays

- Subscription revenues growing, but music discovery function equally important
- Need to understand value of streams as well as downloads
  - $ value - every play rings cash register, repeated plays lead to sales (both downloads and CDs)
    - 60% of our downloaders are not impulse buyers: they purchase after listening 5 times
  - Marketing value - hungry subscribers have voracious appetite for new music: they play things they'd never have considered buying, before

3 Kinds of Charts

1. Airplay: *what's fed to the audience*
2. Sales: *what they actually swallow*
3. Usage: *what they keep down*

- *Music Business has never really had #3 before (Gracenote, Rhapsody, Big Champagne)*
- *Now is the time to start caring about usage: you're getting paid every time someone listens to your records, not just when they buy 'em.*

Subscription Services Tomorrow: The Bulk of Your Business

- Music as a service, not a product
  - No need to walk around with 10,000 songs in pocket, when similar device can connect you to 10 million
  - Access to that much music dramatically alters listener behavior
    - Good for fans
    - Good for business
    - Best for indie artists/labels (they will feel full effect first)

Why?

- When all it costs to try something new is your time, everyone becomes a music geek:
  - *48.5%* (share of total sales generated by top 100 artists at big box physical retail)
  - *33%* (share of total download sales generated by top 100 artists -- lower price, wider selection)
  - *28%* (share of total files traded on P2P from top 100 artists -- no price, unlimited selection)
  - *24%* (share of total tracks played from top 100 artists in Rhapsody - *we beat P2P for music discovery*)

Rhapsody and Music Discovery

- Original Napster was a tool for finding music you already knew about
- Rhapsody designed to answer "Now what?" phenomenon
- Every page leads off in 27 possible directions
- Huge programming staff, but their job is to help subscribers choose their own adventure

Yeah, Yeah, But Where's the $?

- "Pennies per play" sounds small, but...
  - Already 110,000,000+ plays/month in Rhapsody
  - Paying over $500,000/month to indies
  - Individual labels currently earning tens of thousands to hundreds of thousands per year, from Rhapsody alone
  - As subscription services go mainstream, these numbers will multiply tenfold; they will eventually become more important than sales figures

How Will We Make It Mainstream?

- Today, Rhapsody subscribers can listen to whatever they want, whenever they want, as often as they want.
- Next, we add "wherever they want" to that equation.
- Get Rhapsody off PC
  - Rhapsody.com free for curious (and Mac users)
  - Portable devices
    - To Go: great when it works, must improve experience
    - Mobile Phones: platform AND device
  - Direct connect stereo and set top boxes
  - Planes, trains, automobiles (and submarines, and rocket ships, and...)

C

RealNetworks, Music Genres sorted by Total Plays and Sales, Sept. 1, 2006

Source: "artist priority 9_1_06"

Genre	Play Rank	Sales Rank	Overall rank	Demand Plays	% of total plays	Total Sales	% of total sales	Plays + Sales	% of total plays + sales
Grand Total				***107,683,825***		***1,979,552***		***109,663,377***	
Rock/Pop	1	1	1	32,583,351	30.26%	598,970	30.26%	33,182,321	30.26%
Alternative/Punk	2	2	2	20,014,376	18.59%	262,865	13.28%	20,277,241	18.49%
Soul/R&B	3	4	3	10,458,169	9.71%	234,447	11.84%	10,692,616	9.75%
Rap/Hip-Hop	4	3	4	10,071,814	9.35%	237,876	12.02%	10,309,690	9.40%
Country	5	5	5	8,079,666	7.50%	189,642	9.58%	8,269,308	7.54%
Christian/Gospel	6	6	6	3,705,680	3.44%	66,555	3.36%	3,772,235	3.44%
Jazz	7	8	7	3,252,263	3.02%	47,218	2.39%	3,299,481	3.01%
World/Reggae	8	9	8	2,471,752	2.30%	45,357	2.29%	2,517,109	2.30%
Electronica/Dance	9	12	9	2,456,660	2.28%	27,524	1.39%	2,484,184	2.27%
Unclassified	10	7	10	2,025,034	1.88%	48,200	2.43%	2,073,234	1.89%
Classical	11	15	11	1,918,546	1.78%	21,872	1.10%	1,940,418	1.77%
Vocal/Easy Listening	12	11	12	1,732,115	1.61%	32,703	1.65%	1,764,818	1.61%
Comedy/Spoken Word	13	14	13	1,570,121	1.46%	22,671	1.15%	1,592,792	1.45%
Oldies	14	10	14	1,492,999	1.39%	38,498	1.94%	1,531,497	1.40%
New Age	15	17	15	1,409,735	1.31%	15,874	0.80%	1,425,609	1.30%
Soundtracks/Musicals	16	13	16	1,154,933	1.07%	24,756	1.25%	1,179,689	1.08%
Latin	17	16	17	1,103,076	1.02%	21,167	1.07%	1,124,243	1.03%
Folk	18	18	18	961,934	0.89%	15,344	0.78%	977,278	0.89%
Blues	19	20	19	659,272	0.61%	13,109	0.66%	672,381	0.61%
Children	20	19	20	562,329	0.52%	14,904	0.75%	577,233	0.53%

D

E

REDACTED