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

In the Matter of **MECHANICAL AND DIGITAL PHONORECORD DELIVERY RATE ADJUSTMENT PROCEEDING**	))))))))	**Docket No. 2006-3 CRB DPRA**

REBUTTAL TESTIMONY OF

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RIAA Trial Ex. 89

Written Rebuttal Testimony of Mark Eisenberg

I. Introduction

I am Mark Eisenberg, Executive Vice President, Business and Legal Affairs, Global Digital Business Group, at SONY BMG MUSIC ENTERTAINMENT ("SONY BMG"). I have held this position or a similar one as Senior Vice President since the formation of the joint venture between Sony Music and BMG in 2004. In this position, I oversee the worldwide licensing and digital distribution activities of SONY BMG's various music and other intellectual property assets across a wide array of digital distribution platforms and outlets. I am also directly involved in the formulation of SONY BMG's policies and procedures regarding new technologies. I work closely with trade organizations such as IFPI and RIAA in a variety of contexts, including new technologies. I also interact with SONY BMG's marketing and online sales departments worldwide on issues involving digital distribution.

Prior to the formation of SONY BMG, I served as Senior Vice President, Business Affairs, New Technology and Business Development of Sony Music Entertainment Inc. From 2000 to 2001, I served as Senior Vice President and General Counsel, 550 Digital Media Ventures, a venture capital firm started by Sony Music to make strategic investments in companies engaged in technologies, services, and marketing related to digital platforms and media. From 1998 to 2000, I was Vice President, Business Affairs, New Technology and Business Development, Sony Music, and prior to that, from 1996 to 1998, I was Director, Business Affairs, Sony Music. I originally joined Sony Music in 1994 as Counsel in the Sony Music Law Department. I began my career in 1988 as an associate with Wilkie Farr & Gallagher, subsequently moving to the entertainment law firm of Gold Farrell & Marks, where I worked in copyright, music and litigation matters. I earned a Bachelor of Arts degree in 1985

from Brandeis University, graduating summa cum laude and Phi Beta Kappa. I earned a Juris Doctor degree from the New York University School of Law in 1988.

I understand that the music publishers have proposed a cents rate structure for physical phonorecords and permanent downloads, three or four-part "greater of" revenue structures for limited downloads, interactive streaming and ringtones, *and no rates at all for other configurations*. I am submitting this testimony in response to that proposal.

I begin with an overview of the publishers' rate proposal, and why it would be very bad in view of the current state of the music marketplace. I then turn to the importance of a percentage rate structure for mechanical royalties, and particularly how a percentage royalty would enable a number of emerging business models that would be thwarted by the publishers' proposal. Next, I explain why a percentage rate applied to the royalty base defined as part of RIAA's rate proposal is the best approach, and certainly better than the structure of the publishers' proposal. Finally, I explain RIAA's alternative cents rate proposal, which is a poor substitute for a percentage rate but far preferable to the publishers' proposal.

II. Overview of the Publishers' Rate Proposal and the Music Marketplace

Briefly stated, adoption of the publishers' proposal would be a disaster, not only for record companies and digital music services, but also for music consumers, artists and even writers and publishers. This case is very different from the webcasting and SDARS cases that this Court has decided previously, because the licensees under Section 114 are simply distributors.

Here, the basic economics of products generating the vast majority of record company revenues are at stake, and there is a critical symbiotic relationship between record companies and music publishers. Record companies obviously depend upon writers (who are usually our artists

and producers) to create the songs we record, and we want to pay them fairly, but writers and publishers won't make money if their songs aren't recorded. Record companies are the economic engine that drives the music industry by paying for the creation, recording, marketing and distribution of songs. The outcome of this proceeding will determine how many songs we can afford to record, and thus how many songs will become available to the public. It will also determine whether or not we can afford to distribute songs in different types of products and services, and at a variety of price points which are sufficiently attractive to consumers in an increasingly challenging digital entertainment marketplace. If successful, such innovative products and services will fuel sales and licensing revenue for record companies, artists, publishers and writers. And if the economic returns on the record companies' investment are adequate, it will encourage record companies to further invest in the development, maturation and marketing of new creative talent.

That result is necessary to preserve the ecosystem which inextricably links consumers to retailers/services; labels to artists and publishers; and publishers to songwriters. The Copyright Owners have argued that they uniquely should be insulated from the market forces affecting the overall music industry by having the benefit of ever-increasing mechanical royalty rates.[1] But

[1] CO Trial Ex. 3 (Faxon WDT), at 23; CO Trial Ex. 8 (Robinson WDT), at 6-7. I also understand that EMI Music Publishing witness Roger Faxon pointed to his company's agreements with Skype and Spiral Frog as evidence for setting high mechanical royalty rates in this proceeding. While I do not have access to the terms of those agreements because that information has been designated as Restricted, I am generally familiar with those services and with the content acquisition strategies employed by start-up music services in general. Their willingness to pay high royalty rates to music publishers on a speculative basis in order to get into business with untested business models would be a poor basis to impose a high statutory rate. SONY BMG has not licensed Spiral Frog because we are not convinced its service gives rise to a long-term sustainable business model for the record labels, which bear the up-front costs and economic risks relating to the production of recorded music products and the marketing of artists' brands. In light of the fact that Spiral Frog has yet to announce deals with a number of major record labels, the skepticism appears to be somewhat widespread. Skype has not launched

even if this Court was inclined to immunize the Copyright Owners from the ills of the marketplace at-large, they would still suffer the consequences of an ever-changing inter-connected music market. Setting higher and higher mechanical royalty rates in an environment of falling prices won't ensure writers and publishers a steady flow of licensing income when the public has indicated its unwillingness to pay higher (or even the current) prices for music. Rather, it will have a boomerang effect by foreclosing new opportunities for record companies to distribute music, thereby further choking off the flow of licensing income to writers and publishers. Thus, any consideration of proposed rates and rate structures must start with an understanding of the market conditions facing the music industry today.

Other RIAA witnesses have described the terminal decline in the physical product business. Since the filing of RIAA's direct case in November 2006, physical sales and prices have continued to fall. Industry wide CD sales were down substantially in 2007, and sales in the first quarter of 2008 were off substantially relative to the same quarter in 2007. Physical products are likely to be the minority of our business before the end of this rate period, and perhaps by some time in the middle of the rate period. That means that the rates set in this proceeding not only need to enable the creation and distribution of music today, but at a time when CDs might represent a third of our business, and the average wholesale price of a CD

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an on-demand streaming service. The music service with which I believe Skype is involved concerns personalization products such as ringtones – not the core music product which is the mainstay of our business. Moreover that service includes sparse content and has not achieved commercial success. Mechanical royalty rates governing the entire recording industry should not be based on one-off, aberrant agreements entered into by scattered "newcomer" services representing an insignificant portion of the market, whose primary objective is to generate publicity and press (and often-times, seed capital) for their upstart business. Such speculators will overpay for certain "name-grabbing" rights in a desperate attempt to create instant buzz around their service, in the hopes of attracting venture capital investment, consumer hype, or both.

might well be less than seven dollars.[2] However, the publishers have proposed a physical product rate that at the outset is 37% higher than today's rate and will go up over the rate period.

At SONY BMG we are working tirelessly to encourage and foster an attractive digital suite of music products, configurations and services that must be created to replace our shrinking physical business, for which we maintain no false hopes of a resurgence, let alone a near-term flattening out of the precipitous decline. Of course, we all hope that sales of digital products will generate levels of revenue sufficient to continue to discover artists, produce their recordings, and make the kind of marketing investment that is necessary to "break" an artist (i.e., allow him or her to achieve commercial success), but we have no assurances in this regard, and indeed the net impact of the physical decline continues to usurp gains made in the digital realm. The publishers have used words like "flourishing" and "thriving" to describe the digital music market. However, while the total digital revenues of SONY BMG and other record companies have been growing, the digital market is an extremely challenging space in which to do business, and certain product lines like ringtones are now showing declines rather than growth. As an initial matter, the digital market simply isn't very big yet. It represents a larger and larger percentage of our total business by virtue of the overall pie becoming smaller and smaller with the demise of the physical product business. The digital business needs to get a lot bigger – and it needs to grow at much faster pace – to maintain the level of investment in the creation of new music that historically has made the U.S. music industry a robust and consistent supplier of artistic and creative content within the U.S. and around the globe.

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[2] For example, it recently has been reported that Wal-Mart wants to sell hit CDs for $10-12 at retail, catalog titles for $7-9 and budget for $5. Ed Christman, *Wal-Mart Stirs Pricing Pot*, Billboard (Mar. 8, 2008). If or when this comes to pass, our wholesale price would probably be at least 30% less.

And even apart from the small size of the digital business and the fact that its growth is more than offset by declines in the physical business, it is not clear that the growth trajectory of the digital business deserves the kinds of glowing descriptions the publishers have applied to it. It looks like our worst fears about the ringtone business are coming true. We always worried that ringtones might prove to be just a passing fad. We have now seen a leveling off, and in the last several quarters a substantial decline, in the ringtone business. For example at SONY BMG, third quarter 2007 ringtone sales **declined by 15%** relative to the previous quarter. Moreover, that trend has continued: in the fourth quarter of 2007 we experienced a **7% decline**, followed by declines in the beginning months of 2008 as well. Our experience mirrors that in the general marketplace. Just last week, BMI released its annual projection of the U.S. ringtone market, estimating a $50 million (or over 8%) decline in the market from 2006 to 2007.[3] Ringtone prices also seem to be softening.

These marketplace realities notwithstanding, the publishers have proposed a 67% increase relative to the rate prevailing in the marketplace – to 33.3% of wholesale from the extraordinary rate of 20% of wholesale that SONY BMG initially agreed to pay a few years ago. We only agreed to those rates as part of a "package deal" to obtain blanket licenses for a variety of digital products and services to enable a quick entry into the marketplace to avoid missing out on a significant (but fleeting) revenue-generating opportunity while it lasted. Our decision seems vindicated by recent trends, but our willingness to pay high rates under such exigent circumstances cannot be taken as an indication of economics that would be sustainable in the long term or for our core business.

[3] *See* http://www.bmi.com/news/entry/534672.

Seven years after the launch of the first major subscription digital music services, the subscription business model remains very interesting to us. However, market penetration has been modest and very slow, and SONY BMG's revenues from subscription services are essentially flat. To date the major subscription services have been priced to the consumer at $10 to $15 per month. Now, press accounts report talk of subscription services priced to the consumer at $5 a month, and indeed we are being petitioned rather aggressively by subscription services to lower our wholesale prices to enable a consumer price point of $5 or lower. We are being counseled that the mass market adoption of subscription services (where economies of scale can be achieved) requires aggressive reductions in monthly pricing. However, high mechanical royalty rates – and particularly significant per-subscriber or per-play minima – would prevent any such experimentation, since the disproportionate copyright expense would render such services economically unattractive (and indeed money-losing) for both record companies and the services alike.

Sales of digital downloads are growing, but the rate of growth has been roughly linear, and wholesale and retail prices have remained stagnant, if not succumbing to downward pricing pressures. The sale of digital downloads will not soon relieve the extreme cost cutting pressures faced by record companies or restore historic high levels of investment in creating new songs and new recordings. And these pressures will certainly be exacerbated if mechanical royalty rates mushroom by 65% at the outset, as proposed by the publishers, with further increases to follow. By the end of the rate period, downloads are likely to comprise the majority of our total business, exceeding the revenues derived from physical product sales, and this product line will need to shoulder the load of supporting the majority of our production, marketing and overhead costs. During this rate period, if CPI adjustments were to drive the download rate to something

like 17 cents, and wholesale prices remain stuck at 70 cents for a single and roughly $7 for an album (which may prove optimistic), we would be paying about 24% of our revenues from a digital single in mechanical royalties, and close to 32% of our revenues from a 13-track digital album,[4] without the possibility of negotiating that down in our controlled composition clauses due to the statutory preemption of such negotiated rates by the Section 115 statutory rate. That is not a sustainable model for a product representing the majority of our business.

Given the challenges involving today's dominant digital configurations, record companies need to diversify the ways in which their music is offered to the public and foster new and innovative ways of generating revenue from copyrighted recordings. The publishers' proposal threatens to thwart those efforts, in two ways. First, they have proposed a structure that covers less than all of the activities licensable under Section 115. I believe that is contrary to this Court's mandate.[5] But even if it were lawful for this Court to determine rates for only some of the activities specified by Section 115 and not all of them, doing so could delay for years any efforts to launch a product or service that falls in one of the gaps. We have seen that before in the launch of subscription services, DualDiscs and mastertones. That should not be allowed to happen again. Moreover, even if a product is covered, there is a cents rate component to each of the publishers' proposed rates. A cents rate mechanical royalty structure threatens new products

[4] Thirteen tracks is roughly the average number of tracks on our releases, although the number varies widely, from 10 or so on older albums to about 18 on some compilations and releases in urban genres. I understand that for some reporting purposes SoundScan and others sometimes convert single downloads to album download equivalents, and vice versa, using a number of 10 tracks per album. I don't believe that to be a fair average; the market demands that our digital albums have at least the same number of tracks as our physical albums. I believe that the 10-track number is used simply as a convention because digital albums tend to have a retail price ten times the price of a digital single ($9.99 versus $.99), though even the 10x price-point is showing stress and is giving way to pressure to increased discounts (e.g., $7.99 and $8.99).

[5] *See* 17 U.S.C. § 115(c)(3)(C) ("Proceedings under chapter 8 shall determine reasonable rates and terms of royalty payments for the activities specified by this section . . . .").

and services because it cannot possibly be known today what the economics of products that have not yet been conceived will be, and in an environment of generally falling prices, there is a very real risk of setting rates too high.

III. The Importance of a Percentage Rate Structure for Mechanical Royalties

The Copyright Owners have proposed rates that in large part are structured as cents rates instead of rates based on a percentage of revenue. A percentage rate structure, however, is the best way to provide the flexibility that is critical to launching new business models that will hopefully expand the legal distribution of music to the public and generate revenue for all the participants in this proceeding. A percentage rate structure is used in virtually all of SONY BMG's agreements with artists and digital music services, and I urge this Court to adopt RIAA's proposed percentage rate structure in this proceeding. To illustrate the need for a percentage rate structure, and the difficulty in setting cents rates that would accommodate diverse business models, I describe below some examples of new business models that I believe are important to our efforts to expand the market for recordings and songs, and thus create more availability of creative works to the public.[6]

A. Tiered Pricing for Downloads

In the digital music marketplace to date, there has largely been a single retail price point for downloads – 99 cents at retail (corresponding to approximately 70 cents at wholesale). This stands in stark contrast to prices for CDs, which vary substantially depending on whether an album is a new frontline release or a midprice or budget catalog release, whether it's in high-

[6] It bears emphasis that these are just a few business models that are emerging now. At SONY BMG we are always interested in experimenting with ways to make our music more available to consumers and generate new streams of revenue for creators. A percentage rate structure is the best way to provide the flexibility not only for the business models I describe below but also for the ones that haven't been thought of yet.

demand or requires promotional support, and whether the album contains significant bonus features (e.g., special packaging or bonus material). Generally speaking, an album begins its commercial shelf life at a relatively higher price point, and over time, it moves to lower price points. Retail prices for CDs also vary among retail outlets. Variation in pricing makes solid business sense – different recordings have different values to different consumers at different times. And we maximize our revenues from the sale of an album by selling it to as many people as will buy it at a high price when it is new and then gradually lowering the price to attract additional purchasers once consumer demand has somewhat subsided. For new releases, we may also introduce an album at time-limited promotional price-points to draw exposure and hype to a particular release, after which time we raise its price point to take advantage of its increased brand recognition.

SONY BMG is planning to move to tiered pricing for downloads, and we have recently begun to take steps to implement this pricing strategy. For example, in SONY BMG's digital download agreement with one major service, all individual audio tracks are currently offered for 99 cents. However, we have provided for four tiers of retail prices for single audio tracks: 79 cents, 99 cents, $1.29 and $1.49. The agreement also allows SONY BMG to implement a fifth tier of pricing below 79 cents. SONY BMG albums are currently being sold on this service for $9.99, but the agreement also provides varied price tiers at $7.99, $11.99 and $12.99.

We are particularly interested in tiered pricing as a way of generating more revenue for our company. This can be achieved by a combination of: (1) raising our prices on "hits" for which consumers are willing to pay more than the standard price point of $.99 (which iTunes, as the pre-eminent digital download store in the marketplace, has held constant for the past 5 years); and (2) lowering prices on a large number of slower-moving titles to increase consumer value

and spur consumer demand – and to capitalize on the so-called "long tail" afforded by digital distribution and potentially infinite digital shelf space. However, we have been reluctant to introduce a price cut alone. Moreover, the mechanical royalty associated with a lower-price track has made such a price cut cost-prohibitive.

Under the current mechanical royalty rate structure of 9.1 cents per track, mechanical royalties consume a very high proportion – 13% – of SONY BMG's share of the $.99 retail download price (9.1 cents of 70 cents), or 9.2% of retail. Note that the effective 13% wholesale rate (or 9.2% retail rate) is not one that was set by normal market conditions. Faced with rampant internet piracy on peer-to-peer networks and no attractive legal alternative to massive consumption of "free" content by illegal file sharers, the music industry acquiesced back in 2003 to an aggressively priced $.99 single-track download product which was then introduced by the sleekly-designed iTunes Music Store. In the time period preceding the iTunes launch, SONY BMG single-track downloads had been sold directly by SONY BMG to consumers at price points ranging from $1.50-$3.50 per track. Thus, the mechanical royalties at such time (paid at a fixed cents rate of 8 cents in 2002-2003) amounted to just 2.3% to 5.3% of the retail price, which was in line with historical mechanical royalty rate levels. Those percentages are in contrast to 8.1% in relation to the cut-rate iTunes download pricing at the service's launch, which moved to 8.6% shortly after the iTunes launch, and is now 9.2%, by virtue of scheduled rate increases set years before without reference to actual download pricing.

Five years later, in 2008, iTunes stands as the predominant digital download service in the U.S. market, capturing something like 80-90% of all download sales in the U.S. And retail track pricing on iTunes remains exactly where it began back when the service launched in 2003 – while the statutory rate for mechanicals has in fact increased over such time by 13.8%.

Now, if SONY BMG were to introduce a discounted per-track wholesale price which gave rise to a $.79 retail price point, the publishers' newly proposed rate structure would prove exceedingly regressive. At 15 cents per song, the mechanical royalty would engulf 27% of our wholesale price (assuming our the download services' standard split of 70/30 on downloads), or 19% of retail. The publishers also propose CPI adjustments, which might increase the cents-rate mechanical to something like 17 cents by the end of the rate period – resulting in a proportionate share of the wholesale price equal to about 31%. Furthermore, the economics of album downloads, which are bad at the current rates, would be significantly worse coupled with the publishers' higher proposed rates. For example, in the case of a $7.99 album with 13 tracks, the record company might expect to receive $5.59. Under the publishers' proposal, the associated mechanical royalty payment would amount to almost 35% of that at the outset, and assuming CPI adjustments take the rate to about 17 cents, perhaps about 40% by the end of the rate period. These regressive economics have contributed significantly to the marketplace resistance to a move to tiering, notwithstanding the revenue gains that could be achieved therefrom.

A percentage royalty rate structure is the best way to achieve the objectives set forth in Section 801(b)(1) of the Copyright Act when not all products in the marketplace have the same per-track price. We are well-motivated to try to maximize our revenues from the sale of our products. However, the high proportion of our revenues that becomes payable in the event of discounting either requires that we not do it, even if we might expect it to maximize our revenues, or reduces substantially the money available for us to invest in the creation of new recordings, thereby diminishing the availability of creative works to the public. Conversely, I am not opposed to sharing with writers and publishers the upside of higher pricing.

Both RIAA and the Copyright Owners have taken the position in this proceeding that the mechanical royalty rate should reflect an appropriate sharing of the available revenues between record companies and publishers. RIAA does this under the rubric of a royalty denominated as a percentage of all-in wholesale revenues, and the publishers do this under the rubric of "total content costs" or "TCC," but in the ordinary case they are the same thing. Accepting that it is the ratio of the shares that matters, I do not understand how the second and third of the Section 801(b)(1) objectives could be achieved by an approach that is insensitive to price. A percentage preserves the same ratio across all price points, affording the copyright owner the same relative return and the copyright user the same relative income under the applicable economic conditions. It also reflects their relative roles to the same extent across all price points.

B. Music Bundled with Devices or Internet Access

One new business model that we are very excited about, but which has caused some confusion with respect to the application of a percentage-based royalty, is music bundled with the sale of devices such as cell phones, portable digital audio players (MP3 players) and even desktop computers. For example, Nokia recently announced "Comes with Music." As described by Nokia:

> Nokia Comes With Music [is] a revolutionary program that enables people to buy a Nokia device with a year of unlimited access to millions of tracks from a range of great artists - past, present and future. Once the year is complete, customers can keep all their music without having to worry about it disappearing when their subscription is over.[7]

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[7] Nokia unveils "Comes With Music," *available at* http://www.nokia.com/A4136001?newsid=1172937. SONY BMG has not entered into an agreement with Nokia for "Comes with Music," although I understand from public reports that Universal Music Group has.

While Nokia is proposing to bundle permanent downloads with the purchase of a consumer electronics device, such bundling opportunities are also ripe for connectivity or "utility" services, like Internet broadband access and mobile telephone access. In such an offering, consumers could be offered access to a complement of permanent downloads, limited downloads and/or streams. Such content would be "bundled" within an overall internet service provider ("ISP") plan, or within a mobile telephone company's data plan. Consumers might receive (i) "all you can eat" access to streams or conditional downloads and/or (ii) a fixed number of permanent downloads during a particular period (e.g., per month or per year), coupled with various renewal options for additional fixed time periods (e.g., monthly, quarterly or yearly) or perhaps added as a premium subscription tier to a utility bill (like HBO or premium sports channels on cable TV, and "call-waiting" or text-messaging services for the telephone), on an indefinite or "opt out" basis.

This is an intriguing business model. From the consumer's perspective, "all you can eat" and auto-billing features are extremely attractive if appropriately priced. And for service providers and content owners alike, guaranteed "up-front" payments and/or recurring billing models can prove financially rewarding if appropriately priced. Further, these types of bundling options – either with hardware devices or utility service packages – will undoubtedly expose legitimate music services to tens of millions of consumers, and will provide a tremendous boost in educating consumers about the vast number of digital music offerings that are available in the marketplace at affordable prices.

However, like any new business model, this one requires trial and error in testing various content offers and corresponding price points We don't yet know what incremental charges music consumers will accept, how much consumption will be made of these services and what

effect such models will have on our existing transaction-based business paradigm, such as a la carte downloads through online stores (like iTunes and Amazon.com). As a result, the effective per-track price realized by a record company pursuing this business model remains to be seen, and could change substantially over the course of a few years of experimentation. The probability in any event is that the effective per-track price under a bundling model will ultimately be significantly lower than for transaction-based downloads traditionally sold on an a la carte basis. However, the volume of sales and licensing activity could scale significantly and provide significant net benefits for the music industry overall – for labels, artists, publishers and writers alike.

The reason to consider this kind of deal is that the aggregate revenue that music creators receive per device may prove to be much higher. For example, it has been widely observed that roughly 20-25 tracks are purchased from the iTunes Music Store for every iPod sold.[8] That equates to only about $20-$25 in retail revenues, or $14-$17.50 in wholesale revenues, from the sale of transaction-based downloads per iPod. The opportunity to multiply that revenue-per-iPod number, which would then be shared among creators and content owners – even if it were to reduce the effective "per-recording" fees – could prove to be financially attractive to all.

Mechanical royalties payable on a high cents rate basis are a major impediment to this business model because of the likelihood that effective per-track prices will be much lower than current a la carte prices. Particularly in the absence of experience with usage, with a cents rate royalty, whoever commits to be responsible for the mechanical royalties associated with this kind of offering could easily end up paying most of its revenues (or more than its revenues) in

[8] *E.g.*, Sales of iPods and iTunes Not Much in Sync, N.Y. Times (Dec. 11, 2006), available at http://www.nytimes.com/2006/12/11/technology/11drill.html?_r=2&oref=slogin&oref=slogin.

mechanical royalties. By way of illustration, consider how the effective mechanical royalty rates rise as the per track price falls:

Per Track Wholesale Price	Effective Rate at 9.1¢ Per Track	Effective Rate at 15¢ Per Track
70¢	13%	21%
60¢	15%	25%
50¢	18%	30%
40¢	23%	38%
30¢	30%	50%
20¢	46%	75%
10¢	91%	150%

The foregoing illustrates that a bundled device or "comes with music" MP3 player is a risky business model with any cents rate, and probably a prohibitive one without a very low cents rate. By contrast, a percentage rate would enable this business model, which might bring more money into the music industry to be shared among creators.

I understand that there were questions during the direct case trial concerning how the revenue base would be determined when music is bundled with the sale of a device. Under the RIAA's rate proposal, determining the revenue base is simple. For example, if SONY BMG were to enter into an agreement with a cell phone manufacturer or service provider that enabled customers to access music when they purchased a cell phone, the revenue base for purposes of calculating the mechanical royalty payments due to musical works copyright owners would be the revenues that SONY BMG received from the cell phone company. The fact that the cell phone company is offering a bundle to the consumer is irrelevant. SONY BMG doesn't sell cell phones or cellular service; we sell music. And when we get paid for music – no matter how the cell phone manufacturer or service provider might charge the consumer for such access and consumption (e.g., per phone, per subscriber, per megabyte transfer over the cellular network, or otherwise) – we would receive payment from the manufacturer or service provider. That

payment would serve as the royalty base for royalty participants – both publishers and artists. If RIAA's amended rate request were adopted, SONY BMG would allocate 9% of the payment it received from the cell phone company to the owners of copyrights in the musical works that customers downloaded.

C. Download Rent to Own

Probably the largest impediment to consumer acceptance of digital music subscription services has been the reluctance by consumers to pay for music throughout the duration of a subscription, only to find, at the end of the subscription, that they have nothing in their permanent collection. An obvious solution would be to allow subscribers to keep a certain number of their favorite recordings as permanent downloads.

It is not clear how this business model fits into the Copyright Owners' rate request. They have proposed a four-part royalty rate for limited downloads that is the greatest of (i) 15% of revenue (not clear whose, but presumably the service's); (ii) one third of TCC; (iii) $0.0033 per use; and (iv) $0.00064 per minute of playing time per use (with the latter two subject to CPI adjustment). They have proposed a cents rate for permanent downloads of 15 cents per song (or 2.9 cents per minute of playing time), with CPI adjustments.

In thinking about how to apply the Copyright Owners' proposal to a subscription services deal, the revenues of the service and record company are obviously determinable for any accounting period. However, the publishers don't propose a means of allocating these revenues among limited downloads, interactive streams, and permanent downloads, or among the relevant songs distributed in each form. There would need to be some kind of allocation.[9] More

[9] Of course, if that allocation did not take into account plays and long works, which sounds like an administrative nightmare, the publishers' proposed minima could drive the aggregate payments out of proportion to an allocation made on some other basis.

specifically, if a service allowed subscribers to listen to limited (timed-out) downloads on an "all you can eat" basis as part of a sampling/discovery service and to keep a limited number of tracks permanently – perhaps embodying their favorite selections –what would be the result? Would 15 cents then be payable on top of the payments that may have been made for years to cover use of the song as a limited download? Simply providing a reduced cents rate for limited downloads likewise would provide a windfall for the publishers of the songs converted to permanent downloads, unless the cents rate payment was creditable to the permanent download payment once a conversion was made. Hybrid models which marry timed-out sampling and discovery with permanent ownership are critical to the success of the annuity-like service models. While consumers are very much enamored by the wide smorgasbord of music within the present "all you can eat" subscription services, they nonetheless express frustration – resulting in "churn" or cancelled subscriptions – because they are unable to retain permanent ownership of their favorite tracks, absent ala carte transaction-based re-purchases. Such "either/or" business models create dissatisfaction amongst consumers and lead them to "pass" altogether on signing up for subscription services or buying music through legitimate online retailers.

A percentage rate that is consistent across a broad spectrum of uses and has flexible, fair and reasonably objective rules for allocating revenues would make this kind of model possible. Under RIAA's rate proposal, 9% of the record company's all-in wholesale revenue from the service would be paid as a mechanical royalty.[10] The revenues would be allocated between the permanent downloads and limited downloads/streams in proportion to their separate published

[10] If the service rather than the record company obtained the mechanical licenses, the service's royalty would be 9.9% of the amount it pays the record company (the equivalent of a 9% of wholesale royalty, as contemplated by the publishers' TCC construct).

prices, or if those are not available, in a reasonable and non-discriminatory manner.[11] Thus, RIAA's proposal would make possible this model, on economics that are predictable and that preserve the sharing of revenues between record companies and publishers that both have identified as appropriate.

D. Digital Album Cards

Digital album cards are a new product that SONY BMG released in January 2008 under the name "MusicPass." We have now released about 40 titles under the MusicPass digital product line. A MusicPass album is a wallet-sized gift card with a scratch-off backing revealing a code which a consumer uses to download a digital album or track-bundle at MusicPass.com. The digital albums typically include two or three extra audio tracks not included on the corresponding CD release, plus additional bonus content, such as music videos and artist interviews. The suggested retail list price for a single MusicPass album is $12.99. We have also released a number of titles where, for a $19.99 suggested retail list price, we offer users the right to download a second album from the same artist – to generate more revenue from customers who otherwise might not be inclined to buy two albums at one time. The double-album offering is attractively priced at the $19.99 suggested retail price (versus 2 x $12.99) to encourage customers to choose such higher-volume bulk purchases. The MusicPass digital albums can be played on all MP3 players, including iPods, and on computers. In the United States, MusicPass cards are available for sale at Best Buy, Target, Fred's, Winn-Dixie and selected other retail outlets.

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[11] It bears emphasis that the publishers are apparently comfortable with this kind of allocation, because they have proposed a structure that requires doing a similar kind of allocation; they just have not told this Court how it should be done and have introduced cents rate minima into the mix that would only serve to add administrative complexity and serve to disproportionate re-allocate the royalty base to them, relative to the labels.

As other witnesses have explained, retail space for CDs has rapidly disappeared as numerous record stores, including most notably Tower Records, have closed their doors. The digital album cards are a way for SONY BMG to secure additional points of sale and to get its music into more "brick and mortar" physical retail outlets. Because the cards require considerably less shelf space than CDs, they are especially attractive to merchants who have not previously sold CDs – e.g., convenience stores, grocery stores, card shops, truck stops and newsstands, and have the potential to expand exponentially the range of outlets from which music is currently available in the retail market. We are hopeful that the placement of a compelling music product before consumers in a variety of everyday retail settings will increase the size of the music market – to the benefit of everyone involved.

It is still early to tell whether this concept will succeed, and we expect that in any event it will take time to achieve significant market penetration and consumer acceptance. However, our retail partners are happy with the product, so we are hopeful it will enjoy some success.

We believe that one of the important features of MusicPass is our making available to consumers content that they could not get on the standard physical or download album, as well as video content that they are unlikely to be able to steal through an infringing peer-to-peer service. However, we remain very concerned about our costs in rolling out this product, as the inclusion of bonus audio tracks drives up our mechanical royalty cost, and in addition, publishers may receive synchronization royalties for the bonus video content. At the current mechanical royalty rate at 9.1 cents, the $1.46 mechanical royalty cost of a 16 track digital album is not sustainable across a broad range of our products. The publishers' proposal to increase the mechanical royalty cost on a 16 track digital album to $2.40 at the outset and perhaps something like $2.72 by the end of the rate period is even more oppressive. A cents- rate mechanical

royalty rate structure significantly constrains the amount of such content we can make available, and if a cents rate is established in this proceeding (particularly an increased cents rate), it would dampen our enthusiasm for the prospects of widespread commercial success of the MusicPass concept.

E. Ad-Supported On-Demand Streaming Services

I believe it is strategically important for SONY BMG to explore on-demand streaming services that are offered at no or low-cost to consumers, and supported by the sale of advertising. There are many music lovers who currently experience our creative product without paying for it. If we don't provide them legitimate ways to obtain on-demand access to the music they want, they will simply steal it. Ad-supported services provide a potential breakthrough. And in addition, they provide an opportunity to up-sell users to transaction-based permanent downloads-to-own, or premium subscription services (such as a portable "all you can eat" service).

It remains to be seen how much advertising revenue these kinds of services will be able to generate. Today, there are only a handful of advertising-supported on-demand streaming services in operation, and they have launched fairly recently. For example, Last.fm recently began offering free on-demand streams of songs, with a limit of 3 streams of a particular song by a user; and the online community imeem also allows users to stream songs on demand.

I understand that such a business model might involve the making of incidental digital phonorecord deliveries ("DPDs").[12] This Court is to determine royalty rates that distinguish these DPDs "where the reproduction or distribution of a phonorecord is incidental to the transmission which constitutes the [DPD]" from DPDs in general. 17 U.S.C. § 115(c)(3)(C). Services engaged in ad-supported on-demand streaming are primarily delivering performances of

[12] If these kinds of services do not make incidental DPDs, it does not seem that any service in the marketplace would.

the music, and are required to pay performance royalties. These services need to deliver a copy to the user to enable the performance. (Such a delivery is necessary for there to be a DPD. *See* 17 U.S.C. § 115(d).) However, the user does not retain a copy for playback on subsequent occasions. Thus, any delivery of a copy is incidental to the performance and should bear a very low mechanical royalty recognizing that incidental status.[13]

Because these services are relatively new and there are just a few of them in existence at this point in time, it is hard to determine the appropriate rate at which the streaming services should compensate SONY BMG for the use of our copyrighted sound recordings. This uncertainty has caused us to enter into relatively short term agreements that will allow us to fine-tune the economics of our deals if the services prove viable. Unfortunately, this Court does not have the luxury of revisiting the rates it sets every year to make sure that they are working in the marketplace. The rate this Court sets for on-demand streaming or incidental DPDs will need to work in the marketplace for approximately the next five years. If this Court were to set a rate based on the economics as we perceive them today that proves too high two years from now, record companies and services might have no choice but to discontinue a model that I hope will serve an important role in turning people who are not accustomed to paying for music into

[13] I have occasionally heard suggestions that incidental DPDs must be limited in scope to only those copies which are incidental to other DPDs, such as server copies used to deliver DPDs. That seems to me to fundamentally misread the relevant provisions of Section 115. Section 115(d) provides a definition of DPD ("each individual delivery of a phonorecord by digital transmission of a sound recording which results in a specifically identifiable reproduction"). Sections 115(c)(3)(C) and (D) then divide the universe of DPDs into two categories – incidental DPDs and DPDs "in general" – and require this Court to distinguish between them. The language describing incidental DPDs clearly refers to reproduction or distribution being incidental to the particular transmission that constitutes the incidental DPD. It contains no hint that an incidental DPD must be incidental to some other DPD. Make no mistake, I believe that Section 115 covers the server copies used to deliver any DPD (whether it be incidental or general), I just don't think that server copies are themselves incidental DPDs because they are not delivered or distributed, and hence no royalty is payable for them under 17 U.S.C. § 115(c)(2).

people who do pay for music. Again, the answer is a percentage rate, because while there may be no basis for reliably setting a per-stream cents rate, a percentage ensures that publishers always will share proportionally in whatever revenues we can generate from these services.

F. **Promotional On-Demand Streaming**

Marketing our music is a major part of what SONY BMG does, and SONY BMG uses on-demand streams of music as a promotional tool all the time. These promotions can take many forms, and involve either full-length recordings or short (e.g., 30 second) clips. For example -

- An artist's web site (which is frequently operated by the artist's record company) and the label's website typically allow visitors to stream a limited number of an artist's recordings to help market the availability of its products for purchase and other paid uses. At SONY BMG we are very sensitive to giving away access to music which substitutes for paid access. Thus, we often limit promotional access to excerpts or clips. In certain instances, however, it is important to provide consumers with a full-length listen of the music which is available for sale, just as one would expect to hear a heavily promoted song in its entirety on the radio.
- We authorize download sites to stream 30-second clips so that users can preview recordings before they make a purchase decision. This kind of previewing is expected by potential download purchasers today.
- Our marketing department arranges countless other promotions in partnership with our digital distribution partners and others. For example, we might authorize a music site on the Internet to offer free streams of the single from a new album for a time-limited promotion in exchange for targeted and featured placement on websites whose visitors meet the particular demographic of the particular music concerned.

Sometimes we might receive additional promotional consideration, such as ad slots we would similarly use to promote the sale of the music, or information such as fan email addresses to which we can market the sale of the music in a one-to-one setting.

The purpose of these streams is to promote sales and other paid uses of the recordings that will generate revenue for the record company and the music publisher alike. SONY BMG has not, and I'm not aware that other record companies have, paid music publishers mechanical royalties for these kinds of promotional uses. Record company marketing budgets are under extreme pressure due to declining sales and prices. It has become very hard to make the investment in marketing that is necessary to break an artist on the revenues we are able to generate. Accordingly, it would be counterproductive and disruptive, and skew the balance between fair return and fair income and reflecting the parties' relative roles, if record companies had to start paying mechanical royalties twice – once for selling products and again for our efforts to sell the products.

In that regard, it should be remembered that most of the time, the writers of the songs we use in these promotions are our recording artists themselves. And our controlled composition clauses which are negotiated with artists who are seeking to have their music produced, recorded and marketing by the labels, have historically given us free use of their songs for promotional purposes. However, statutory DPD rates apply in lieu of discounted rates under controlled composition clauses in post-1995 recording contracts. Thus, to assess a payment for promotional streams is to require that in the ordinary case we pay our artists to promote their recordings notwithstanding contracts that say we don't have to do so.

A percentage rate works perfectly to address promotional streams. If a record company makes or authorizes streams without receiving revenues, no payment would be due in providing

access to such content. However, the publishers have proposed a cents rate minimum for interactive streams of $0.00275 per use or $0.00053 per minute of playing time, with CPI adjustments. Thus, the record company would not only pay royalties on the albums sold – which of course, we are quite willing to do – but also incremental royalties from its scarce promotional budget for running a promotion from which it generated no additional revenues itself, other than to promote the sale of the product on which it already pays royalties. By way of illustration, if we had a promotion where a million people listened to a song featured on a destination site and we sold 1,000 albums as a result, we would earn about $7,000 from the sales, but pay $2,750 in mechanical royalties for the streams and about another $1,950 in mechanical royalties for the sales (13 tracks x 15¢ x 1,000 units). That is more payment for the promotion than the sales, and a total payment of 67% of our revenues.

Accordingly, if this Court is inclined to adopt a cents rate, or a rate structure with cents rate minima, I strongly support RIAA's proposal that there be a zero royalty for promotional on-demand streams and other incidental DPDs, where the following circumstances exist:

- The stream is made or authorized by the sound recording copyright owner.
- The primary purpose of the sound recording copyright owner in offering the stream is to promote sales or any other paid uses of recordings by the artist or paid use of a service through which an artist's recordings are available.
- The stream is offered free to the end user.
- In the case of a stream through a third party site, the sound recording copyright owner does not receive any cash or other monetary payment for the incidental DPD.

G. Locked Content

An additional product that has intrigued us for a long time is locked content. This incorporates recordings that have been encrypted or otherwise protected by digital rights management, or potentially degraded such as by means of voiceovers, and which are either preloaded on a device such as an MP3 player or the hard drive of a computer, or made available by means of DPD, but where the consumer can only preview the recording on a limited basis without a payment transaction that results in unlocking the recording. The marketing proposition is that if the tracks are available right there on the device when it comes out of the box, the consumer is more likely to buy them than if he or she had to surf the web to sift through a digital music service. Today, we are more acutely focused on digital music services bundled with devices, as described above, but certainly, if we found the right opportunity we would seek to capitalize on the opportunity to distribute locked content as well.

The problem with locked content under the current mechanical royalty structure is that we are not paid by consumers until after a track is purchased (which coincides with when the consumer can actually enjoy the use of that track). However, under the existing rate structure a full mechanical royalty might be claimed when the encrypted tracks are "locked" onto the physical device or media and shipped. Including a thousand encrypted tracks on a hard drive would obviously be cost-prohibitive if that carried a mechanical royalty cost of $91, and even more so at the publishers' proposed $150 – all for music that mostly would never be decrypted.

We addressed this product in our New Digital Media Agreements ("NDMAs"), in which certain publishers agreed that the royalty would not be payable until the purchase transaction (and in the unlikely event we received up-front consideration we would share that with

publishers). However, those agreements are for only limited terms and do not cover all publishers.

A percentage rate structure would address this product configuration automatically. Whenever the record company recognized revenue from locked content, it would pay the publisher. However, should this Court adopt a cents rate structure, or cents rate minima, this rate structure would only be possible with the additional clarification proposed by RIAA as part of its alternative rate proposal that the product is not considered distributed until unlocked.

IV. A Percentage Rate Applied to the Royalty Base under RIAA's Rate Proposal Is the Best Approach

The foregoing discussion should make clear that the whole music industry would be poorly served over the coming rate period by a structure that significantly constrains the ability of record companies and their distribution partners to innovate new kinds of products and services and do what it takes to expand the revenue base in which all creators share. Any cents rate structure or structure with cents rate minima threatens to do that. Certainly a structure with the high cents rates the publishers have proposed would make it impossible (or at least prohibitively expensive) to achieve success with any of the concepts I have described.

By contrast, RIAA's rate proposal has been carefully calculated to ensure that writers and publishers receive a fair, consistent and readily determinable share of the music industry's revenues from the sale of audio products, across all product configurations and price points and over the whole rate period no matter what happens to prices. RIAA's rate proposal is superior to that of the publishers in a number of respects:

- Comprehensive Coverage. The publishers propose to leave gaps in the compulsory license scheme. But a compulsory license without rates that cover everything within its scope is not really a compulsory license. The purpose of this proceeding is to set

rates for all activities within the scope of Section 115, as RIAA's proposal would do by having three rate categories: all physical products and DPDs in general (except ringtones), ringtones, and incidental DPDs.

- Readily Determinable Royalty Base. The publishers' three and four part royalty structures for limited downloads, interactive streams and ringtones have two different percentage royalty bases - something they call simply "revenue" and TCC. Given the ratios between the two, I infer that the former is intended to be the digital music service's revenues. As the person responsible for negotiating SONY BMG's agreements with services, I understand that defining which of a service's revenues should be included in a royalty base involves some complexity because of unique circumstances of each service. It can be a subject of hard bargaining in our agreements with services. The revenues of a record company from wholesale distribution of audio recordings are much more straightforward to determine.[14] We sell recordings or authorize services to sell recordings, and in exchange we receive a price. The price is the record company's revenue from the sale and RIAA's proposed royalty base for the vast majority of products in the marketplace. In cases where the service takes the mechanical license and pays the royalties, RIAA proposes that the royalty be a somewhat larger percentage of the somewhat smaller base of what is paid

[14] The royalty base obviously does not include revenues from activities other than the distribution of audio recordings. Something like 90% of a record company's revenues have historically, and still, come from sales, with virtually all the rest from various kinds of licenses. As the recording business has deteriorated, record companies have started experimenting with artist deals that might lead to other lines of business involving other aspects of artists' careers, such as merchandising or even artist management (so-called "360 deals"). The barriers to entry into these other lines of business are significant, and there are numerous hurdles to success. We also have to buy into these new businesses, such as through larger advances. To the extent that we achieve hard-fought success in lines of business that do not involve the exploitation of songs, there is no reason that publishers should share therein.

to the record company for sound recordings alone. This approach is based on the publishers' concept of TCC and leads to a mathematically equivalent royalty.[15]

- Clear Treatment of Bundling. As I hope the foregoing discussion makes clear, I believe that the future of the music industry lies increasingly in offerings that combine different kinds of products covered by Section 115 and other components. Whether the offering is a subscription service with limited downloads, on-demand streams and permanent downloads, a physical product consisting primarily of audio tracks with a limited amount of bonus video material, a bundle of online products, or otherwise, if we are going to maximize the revenues in which creators share, we need a rate structure that makes it economical to sell the bundle for less than the sum of its parts, with an appropriate rule for allocating the revenues fairly. The publishers' minima make bundling unattractive, but they assume that such an allocation will occur (they just leave the allocation methodology to the imagination). RIAA's proposal is fair, administrable and based on existing practices.[16]

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[15] Another special case RIAA has addressed is direct retail sales by record companies. In view of the extremely small number of these transactions, RIAA has sought to achieve a royalty that is approximately equivalent and readily administrable. The record company's retail revenue (typically the retail price) would be multiplied by a percentage representing a typical spread between retail and wholesale price. In the case of physical products and permanent downloads RIAA proposes that the multiplier be 70%. This is a standard percentage for downloads today. My sense is that 70% is probably a somewhat high percentage for physical products (i.e., RIAA is proposing to pay a higher royalty than might be justified by my sense of typical physical product retail markups). However, so little physical product is sold directly to consumers by record companies that the administrative convenience of applying the same 70% multiplier is sufficient reason to use it, and more precise estimation seems unnecessary. For other uses (i.e., other digital uses), RIAA proposes 50%, which is approximately the share SONY BMG would expect to receive in a ringtone or subscription service deal.

[16] I have sometimes heard concerns that if our recorded music continues to deteriorate, record companies will give away their recordings to sell concert tickets or T-shirts. Record companies are in the business of producing, marketing and distributing recordings. It would make no sense for us to give away the content assets we have spent millions to create and market in order to

V. RIAA's Alternative Cents Rate Proposal

RIAA has proposed an alternative rate request that incorporates cents rates for the vast majority of uses covered by Section 115. I believe this approach is inferior to RIAA's primary rate proposal, but if this Court is disinclined toward a percentage rate structure, this approach is much preferable to the Copyright Owners' proposal.

A primary challenge in setting Section 115 rates that achieve the objectives set forth in Section 801(b)(1) of the Copyright Act is that there is great diversity in both the number of tracks used in recorded music products and the prices at which those products are offered. A percentage rate achieves a proportional allocation of the revenues from the distribution of a musical work and sound recording irrespective of the number of tracks and price, thus contributing equally to the availability of musical works and recordings, and reflecting equally the relative roles of all contributors, irrespective of the number of tracks and price.

RIAA's alternative cents rates seek to approximate the desirable aspects of a percentage rate with a cents rate structure. Most notably, for physical products and a la carte downloads, RIAA has identified five per-track price bands. Physical products and a la carte downloads are almost universally sold at wholesale by record companies, so the wholesale price is apparent, as is the number of tracks. The five price bands span the range of per-track prices in the marketplace – from albums with the highest wholesale prices and/or fewest tracks (where the proposed cents rate represents an increase from today's rate), to low price products and/or a larger number of tracks. Each band is intended to encompass a range of products that exist or are likely to exist in the marketplace. In each case, a cents rate royalty is specified based on the

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pursue collateral lines of business. During the coming rate period it is unrealistic to think that manipulative bundling of recordings with other merchandise could possibly have any material effect on mechanical royalty payments. This question could be revisited in subsequent proceedings in the unlikely event that conditions warranted it then.

midpoint of the band (for the middle bands) or a price five cents into the band (for the first and last bands that have few products, and fewer still at the more extreme prices).

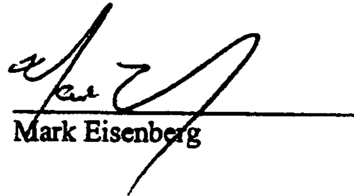
For ringtones a cents rate is provided based on a wholesale price at or a little below the average today. It is probably generous, in that more significant ringtone price declines over the rate period may well occur. For promotional streams like those I discussed above, a zero rate is provided. RIAA does not propose alternative cents rates for other kinds of uses. These represent a small part of the marketplace and are highly varied. I do not believe it makes sense to try to set a cents rate for them, because not enough is known about them to do so on an informed basis for a five year period.

VI. Conclusion

The coming rate period will be a crucial time for the music industry. A decision in this proceeding that allows us to cultivate diverse new revenue streams and expand the music market could be a key element in reversing the negative trends of the last eight years. Conversely, high rates like those proposed by the Copyright Owners that offer the illusion of protecting writers and publishers while foreclosing critically important new business models and pricing options are likely to result in the further deterioration of the music business. Those rates would likely lead to a diminution not only in mechanical royalties but in the other revenue streams of writers and publishers that depend upon a record company's investment for their livelihood. Thus, under the existing market conditions today, it is crucial that this Court adopt a percentage royalty rate at a level below today's rates. For that reason, I strongly support RIAA's rate proposal.

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

Date: April 3, 2008



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