PUBLIC VERSION

Before the
COPYRIGHT ROYALTY JUDGES
Washington, D.C.

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

PROPOSED REPLY FINDINGS OF FACT OF THE RECORDING INDUSTRY ASSOCIATION OF AMERICA, INC.

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I. INTRODUCTION

A. RIAA's Rate Proposal Falls Within the Range of Reasonable Rates Supported by the Evidence.

1. The Evidence Compels a Decrease, Not an Increase, in the Rates.

1. The record in this case is replete with marketplace evidence that the mechanical rate should go down, not up, and nothing in the Copyright Owners' Proposed Findings of Fact provides any basis to conclude otherwise.

2. *The evidence is undisputed that sales and prices of sound recordings sold as CDs and in digital form are down.* Applying the straightforward principles of derived demand on which this Court has based its two prior decisions, these facts compel a reduction in the mechanical royalty rate, not an increase. If consumers and retailers are buying less and paying less for musical works embodied as CDs and digital downloads, the Copyright Owners should be receiving less on a per-unit basis.

3. *The evidence is undisputed that the ratio of the current statutory mechanical rate to the wholesale price of sound recordings is higher than it has been in recent memory.* This is in great part a function of the step increases negotiated in 1997 which presumed continued increases in sound recording prices—an assumption that has proven to be wrong in the current marketplace. Once again, on this record, there is no basis for increasing the rate further, and there is strong evidence to support a significant decrease.

4. *The weight of the evidence demonstrates that the statutory mechanical rate is a higher percentage of the wholesale price of sound recordings than in any country throughout the world.* Even accepting the haphazard analysis of international rates provided by the Copyright Owners, the evidence demonstrates that the current mechanical rate for digital downloads is higher in the U.S. than virtually anywhere in the world, and the current mechanical rate for

physical products in the U.S. is among the highest in the world. On this record, it is impossible to conclude that an increase is required; only a decrease makes sense to bring the rates in line with international norms.

5. *It is undisputed that record companies have cut all of their costs as an absolute matter over the last seven years—with only mechanical royalties holding steady as prices, revenues and other expenses fall.* The 1981 CRT held that it was unfair for record companies to spend more on all of their other expenditures, such as A&R, marketing, and distribution, but spend relatively less on mechanical royalties. The record is undisputed that record companies—faced with sharply declining revenues and declining prices—are paying less to everyone except the Copyright Owners, who are benefiting from an excessive mechanical rate today.

6. *Each and every day songwriters agree to rates well below the statutory rate because that is what the market will bear, and music publishers invest most heavily in singer-songwriters who have agreed to rates well below the current statutory rate through controlled composition clauses.* The record is undisputed that, even when not subject to the compulsory license, songwriters and music publishers willingly agree to rates well below the current statutory rate. While they decry the operation of controlled composition clauses and complain that they "have to" agree to these rates because that is the only way to get a song recorded, that is simply a manifestation of the marketplace. And songwriters and music publishers amply demonstrate the reasonableness of the rates actually negotiated in the marketplace by agreeing to them (in the case of songwriters) and investing heavily in advances for singer-songwriters (in the case of music publishers).

7. All of these marketplace factors compel the conclusion that the rate in this proceeding should go down, not up. All of them are devastating to the Copyright Owners' claim

that the rates must go not just up but up drastically, to levels vastly higher than they have ever been in history, vastly higher than other countries, and to levels that would essentially erase whatever profit that record companies currently earn. As the Court begins the process of setting rates, it must keep in mind that, directionally, the rates must go down.

2. The Battle of the Benchmarks Is Not Close.

8. In past cases decided under Section 801(b), this Court and other decision-makers have found that marketplace benchmarks provide a useful starting point for determining a rate consistent with the four statutory factors. *Determination of Rates and Terms for Preexisting Subscription Services and Satellite Digital Audio Radio Services*, 73 Fed. Reg. 4080, 4088 (Jan. 24, 2008) ("*SDARS Decision*"); *Determination of Reasonable Rates and Terms for the Digital Performance of Sound Recordings*, 63 Fed. Reg. 25394, 25049 (May 8, 1998) ("*PES I Librarian's Decision*"). In this proceeding, only RIAA has even attempted to follow this Court's prior direction on the proper analysis of the comparability of benchmarks.

9. The Copyright Owners continue to rely on inapposite benchmarks unsupported by a shred of expert testimony suggesting they are minimally comparable to the hypothetical transaction at issue here—*i.e.*, the negotiation of mechanical rates for use of compositions in sound recordings sold to the public as CDs and digital downloads. They purport to acknowledge that "'[c]omparability' is a key issue in gauging the relevance of any proffered benchmarks." CO COL ¶ 29 (quoting the *SDARS Decision*). But their benchmarks, the synch rights market, the Audio Home Recording Act, and rates negotiated for mastertones in bundled agreements, are anything but comparable. Indeed, Dr. Landes—the sole witness testifying as to benchmarks for the Copyright Owners—failed to undertake any comparability analysis at all, simply ignoring the critical importance of the actual consumer markets in which these products operate.

10. In the end, the Copyright Owners' benchmarks bear all the hallmarks of having been hand-selected by an expert trying to find a way to support a predetermined, if otherwise implausible, outcome—a dramatic increase in the mechanical rates in the current economic climate. The essence of Dr. Landes's testimony is that, if the record companies and the Copyright Owners sat down tomorrow to negotiate mechanical rates, unconstrained by a statutory scheme, they would increase the current rate by (to use downloads as an example) somewhere from 50% (14 cents) to 300% (35 cents). To describe this so-called "range of reasonableness" in concrete terms is to see how utterly useless the Copyright Owners' benchmarks are.

11. By contrast, RIAA's proposed benchmarks—derived from current voluntary deals for mechanical rights to make sound recordings, historical practice, and rates for the same rights in other comparable countries—all involve the exact same rights and uses that this Court is called upon to price. So comparability is not an issue. Taken together, these benchmarks send a powerful message: the current mechanical rate of 9.1 cents for CDs and digital downloads is entirely too high in relation to what the free-market rate would be.

12. Moreover, while the Copyright Owners repeatedly contend that the songwriters "received barely a mention" by RIAA in this proceeding, *see, e.g.*, CO PFF ¶¶ 6, 218, the *only* party in this proceeding to offer market benchmarks involving songwriters is RIAA—not the Copyright Owners. RIAA's benchmarks include agreements made by both singer-songwriters and pure songwriters. *See* RIAA PFF Section III.C. Not a single one of the Copyright Owners' benchmarks is an agreement between a songwriter and another party. The Copyright Owners cannot have it both ways, arguing that "songwriters represent the true economic interest at issue

in this dispute," CO PFF ¶ 6, yet failing to offer any economic benchmark demonstrating what songwriters are able to collect in the marketplace.

13. The Copyright Owners' continued reliance on the proposed synch rights benchmark is truly remarkable given the largely undisputed evidence that these transactions (1) occur long after the costs of making and marketing sound recordings are sunk, and (2) occur in a setting where the leverage of publishers relative to that of recording companies is uniquely magnified because of the existence of re-recording options. This Court has twice rejected reliance on the synch rights market to support the suggestion that musical work and sound recording rights are equally valuable in other market settings. The Copyright Owners have not even tried to suggest a reason why the Court should change course now. To the contrary, the only party to call a witness with direct knowledge of the synch rights marketplace was RIAA, which called Scott Pascucci. He reaffirmed the uniqueness of the synch rights context.

14. The AHRA was barely defended at trial by Professor Landes, and even now the Copyright Owners only are willing to say that the AHRA provides some "corroboration" of their other two benchmarks. CO PFF ¶¶ 52, 543. It fails as a benchmark for several reasons, not the least of which is that it is noncomparable legislation from 1992, not a market-based rate.[1]

15. Ultimately, then, the Copyright Owners' hopes and their entire case depend on the mastertone benchmark. Yet this Court has heard extensive testimony establishing the multiple problems with using that benchmark to set a price for mechanical royalties for CDs and permanent downloads. This was both a new and a potentially fleeting product, with uses and economic characteristics quite dissimilar to those of recordings sold for entertainment. The

[1] *See* 2/11/08 Tr. 2105:19-2106:4 (Landes) ("Well, it's useful, but I'm not sure it's quite as useful as the other two benchmarks. *Because one of the characteristics of a useful benchmark, which I described at the outset, was that it was the result of market negotiations* . . . . Here, we're talking about legislation. So it's not a market; it's legislation.") (emphasis added).

publishers had great leverage in the negotiation of the NDMA mastertone price because they were already receiving substantial royalties on polyphonic and monophonic ringtones while the record companies were collecting nothing. To get that mastertone price, the publishers also made major concessions with regard to DualDisc, locked content, videos, etc. *See* RIAA PFF ¶¶ 885-964. All of these facts help explain the enormous gap between the NDMA mastertone rates and what record companies are currently paying for mechanical rights for sound recordings.

16. It is the latter that is the more valid benchmark. Although the Copyright Owners nitpick Dr. Wildman's testimony about current voluntary mechanical rates, ultimately they cannot dispute that many, if not most, voluntary deals are well below 9.1 cents. And the reason is clear: there are a great many songwriters and publishers competing to win spots on the limited number of sound recordings that the record companies are willing to invest in.

17. The Copyright Owners complain that none of the voluntary deals studied by Dr. Wildman is entirely unaffected by the existing statutory rate. But what matters is that all the variations from the statutory rate are in the same direction—down. And it ill-behooves the Copyright Owners to argue that benchmarks must be entirely independent of an existing statutory scheme when one of their benchmarks is a *statutory* division of royalties in the Audio Home Recording Act.

18. In any event, the Copyright Owners' argument that this Court cannot consider the rates actually negotiated in the marketplace because they are not "independent," CO COL Section III.D, is directly contrary to Section 115 itself, as well as numerous prior copyright royalty decisions. Section 115 expressly authorizes the Court to examine the actual agreements that parties negotiate in the marketplace for mechanical licenses. Under 17 U.S.C. § 115(c)(3)(D), "[i]n addition the objectives set forth in section 801(b)(1), in establishing such

rates and terms, the Copyright Royalty Judges may consider rates and terms under voluntary license agreements described in subparagraph (B) and (C) [the provisions authorizing negotiation of voluntary agreements]." Thus, any argument that such agreements are, by their very nature, improper for consideration as benchmarks in this proceeding cannot be squared with Congress's express direction to the Court.

19. The Copyright Owners' criticisms of RIAA's other benchmarks—all of which are benchmarks consistent with Dr. Wildman's analysis—are similarly unavailing. The Copyright Owners complain that Dr. Teece's examination of rates over time goes too far back into the past, but that criticism both ignores the 1981 CRT's decision, which expressly looked at royalty rates over time to determine a fair division of the profits of the music industry, and prior decisions in other copyright royalty proceedings in which the CARP and the Librarian expressly adopted analyses that "trended forward" rates from proceedings two decades old. The Copyright Owners also criticize any consideration of foreign royalty rates, ignoring that the CRT expressly used foreign rates as a benchmark and that the D.C. Circuit made clear that the Court need not "close its eyes to conditions in other countries while deciding what a fair return to a composer should be." *Recording Indus. Ass'n of Am. v. Copyright Royalty Tribunal*, 662 F.2d 1, 10 n.23 (D.C. Cir. 1981).

20. In the end, what the Copyright Owners are asking this Court to do is to protect them from the operation of the market by setting an artificially high mechanical rate that they hope will alter the voluntary deals negotiated in the future. The Court should not accept that invitation. Its job is to set a mechanical rate that reflects the value of mechanical rights in the marketplace, with any needed adjustments to reflect aspects of the four statutory factors not fully reflected in a market rate. Doing that job here requires a substantial rate reduction.

3. The Reasonable Range of Rates Derived from RIAA's Benchmarks and a Proper Analysis of the Copyright Owners' Benchmarks Lead to a Range of Reasonable Rates Consistent with RIAA's Rate Proposal.

21. As discussed in RIAA PFF Section III, RIAA's benchmarks provide a strong starting point for the Court's analysis of the rates. Looking at the rates actually paid in the marketplace for mechanical royalties, as well as the rates negotiated by songwriters who are not subject to any controlled composition clause and who are not subject to the compulsory license for the first use of a musical work, reveals that these free market negotiations yield a mechanical rate between 5.25 cents and 7.8 cents per track. RIAA PFF ¶ 659. Average effective royalty rates for first uses by pure songwriters range between 6.9 cents and 7.8 cents. RIAA PFF ¶ 657.

22. International rates in the most comparable markets, the United Kingdom and Japan, suggest similar numbers. The standard effective mechanical rates in Japan are 4.53% of the retail price for physical products and 6.54% of the retail price for digital downloads (*see* RIAA PFF ¶¶ 716-719), which equates to a cents rate in the United States of 5.1 cents for CDs[2] and 6.5 cents per track for downloads.[3] In the U.K., the mechanical rate equates to 7.7% of the wholesale price of digital downloads (*see* RIAA PFF ¶ 741), which is 5.4 cents per track in the United States.[4] The U.K. rate for physical products is 8.5% of the Published Price to Dealer (*see* RIAA PFF ¶¶ 720-721), which equates to a rate of 8 cents per track in the United States.[5]

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[2] The average retail price of a CD in 2005 was $14.69 (RIAA PFF ¶ 199), or $1.13 per track (assuming 13 tracks per CD), and that retail price per track times 4.53% equals 5.1 cents.

[3] The retail price of digital downloads on Apple's iTunes of 99 cents, times 6.54%, equals 6.5 cents.

[4] Bruce Benson's testimony indicates that the record companies received an average wholesale price for digital singles of 70.2 cents per track in 2006, (Benson WRT at 16, RIAA Trial Ex. 82), and 70.2 cents times 7.7% equals 5.4 cents per track.

[5] According to the testimony of the Copyright Owners' witness, Mr. Fabinyi, record companies in the U.K. sell at prices discounted from PPD by as much as 40%, but on average at a discount closer to half that. 5/18/08 Tr. 6821:11-6822:19 (Fabinyi). Even assuming a 25% discount from

23. This range of rates is also consistent with historical norms, as well as Dr. Teece's analysis which trended forward the rates set by the CRT in 1981 to account for changes in the marketplace—in particular the wholesale market for sound recordings. As Dr. Teece found, if one trended forward the rates set by the CRT, they would equate to a rate of approximately 7.8% of wholesale. Even if one accepted the Copyright Owners' critique of how Dr. Teece did the calculation, the royalty rate for CDs and digital downloads would still come out to 8.7% of the wholesale price.

24. This range of rates presented by RIAA using multiple benchmarks is in one sense consistent with the evidence presented by the Copyright Owners themselves. As discussed above and in more detail below, the Copyright Owners' three proposed benchmarks are deeply flawed. But to the extent that the Copyright Owners' benchmarks and economic analysis provide any useful information at all, they support RIAA's contention that the mechanical rate should be reduced from its present level. For example:

- Although RIAA does not believe that the mastertone market is sufficiently comparable to the market for CDs and digital downloads to serve as a useful benchmark, Dr. Wildman's analysis of how the surplus from sales of mastertones was divided between record companies and music publishers yields the conclusion that the same division of the surplus from CD and download sales would produce a mechanical rate of 7.7 cents per track. Wildman WRT at 49-52, RIAA Trial Ex. 87.

- The Copyright Owners' expert Professor Murphy conceded that his analysis did not justify an increase in the rates, but argued that the mechanical royalty rate should "evolve in much the same way" as the payments that record companies make for other creative inputs, such as artist royalties and A&R. Murphy WRT at 8-9, CO Trial Ex. 400; 5/15/08 Tr. 6887:15-6890:2 (K. Murphy). If that is so, the Court should set the mechanical rate at 7.1 cents per song, because record companies paid the same amount per unit for non-songwriter creative inputs in

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PPD, that would make the effective mechanical rate approximately 11.3% of wholesale. The per track wholesale price of physical products in the U.S. was 70.5 cents in 2006 (*see* Benson WRT at 15, RIAA Trial Ex. 82), and the U.K. effective mechanical rate applied to the U.S. wholesale price per track is 8.0 cents.

2006 (the last year for which data is available) that they paid in 1999, when the mechanical rate was 7.1 cents. Benson WRT at 15, RIAA Trial Ex. 82.

- Attempting to rebut RIAA's evidence regarding international rates, the Copyright Owners presented Jeremy Fabinyi. Mr. Fabinyi made a point of explaining that the "Canadian offline rate is of particular note," and submitted the March 16, 2007 Canadian Copyright Board decision setting the mechanical rate for the use of musical works online as an exhibit to his written testimony. *See* Fabinyi WRT at 11 and Ex. E, CO Trial Ex. 380; RIAA PFF ¶ 765. Mr. Fabinyi translated the Canadian mechanical rates into U.S. dollars, and concluded that the Canadian rate for physical products is 7.9 cents per track in U.S. dollars, and the Canadian rate for downloads is 8.51 cents per download in U.S. dollars. *See* CO PFF ¶¶ 722-723 (citing Fabinyi WRT at Exs. F-1 & F-2).

25. The current mechanical rate, expressed as both a cents rate and a percentage of wholesale revenue (using 2006 wholesale price data, *see* RIAA PFF ¶ 703) is:

Current Mechanical Royalty Rate	
Cents Rate	**% of Wholesale Rate**
9.1¢	14.8%

26. Using the average wholesale price of 71.7 cents per track from the analysis of Bruce Benson (Benson WRT at 15, RIAA Trial Ex. 82), the rates in the paragraphs above can easily be converted from cents rates into percentage of wholesale rates, and vice versa. Based on the marketplace benchmarks and economic analysis summarized above, the appropriate mechanical rate for CDs and digital downloads would fall in a range between 5.1 cents and 8.5 cents per track, and these cents rates correspond to percentage rates ranging from 7.1% of wholesale to 11.9 % of wholesale. The chart below summarizes these benchmarks:

RIAA Benchmark Mechanical Royalty Rates		
Benchmark	**Cents Rate**	**% of Wholesale Rate**
Japan Rates	5.1¢ - 6.5¢	7.1% - 9.0%
Average Effective Royalty Rate in Free Market Agreements	5.25¢ - 7.8¢	7.3% - 10.9%
U.K. Rates	5.4¢ - 8.0¢	7.7% - 11.3%
Teece Analysis of Historical Norms	5.6¢ - 6.2¢	7.8% - 8.7%
Average Effective Royalty Rate for First Uses By Pure Songwriters	6.9¢ - 7.8¢	9.6% - 10.9%
Re-Analysis of K. Murphy	7.1¢	9.9%
Wildman Mastertones Analysis	7.7¢	10.7%
Canada Rates	7.9¢ - 8.5¢	11.0% - 11.9%

27. As can be seen from the chart above, RIAA's proposal that the mechanical rate for physical products and digital downloads be set at 9% of wholesale revenue falls squarely in the middle of the range of rates supported by the benchmark evidence. Moreover, as we discuss below, the Section 801(b) factors would, if anything, militate in favor of a rate lower than the market rates revealed by the benchmark analysis.

28. Finally, as discussed in RIAA PFF Section IV.D and below, because ringtones are consumed for different purposes and have different supply and demand characteristics than CDs and digital downloads, economic theory compels the conclusion that a different rate should be set for them. Just as the Court found that the PES services and the SDARS services were

different markets requiring that rates be set differently and commercial and small non-commercial webcasters were in different submarkets requiring that rates be set in a differently, so too rates for CDs and digital downloads (which inhabit the same market) must be set differently from rates for ringtones. Dr. Wildman has provided the Court with a range of estimated rates for ringtones from somewhere above 14% of wholesale (based on his analysis of the division of surplus) and somewhere below 20% of wholesale (set forth in the NDMAs). The cents rates in the NDMAs examined by Dr. Landes suggest rates of 10-12 cents per ringtone. In the event that the Court finds the NDMAs a persuasive benchmark for the setting of rates for ringtones, the record compels the conclusion that (a) the rates for CDs and digital downloads must be set on the basis of the benchmarks presented by RIAA and the analysis depicted in the table above, and (b) other provisions of the NDMA agreements implicated here, such as the manner in which royalties are calculated for multi-session products and locked content, must also be given force and effect, as they are in RIAA's Second Amended Rate Proposal.

B. The Copyright Owners Simply Deny Economic Reality.

29. The basic problem facing the Copyright Owners is that they are seeking to justify raising, rather than lowering, the current mechanical rate at the end of a decade during which they have experienced relatively steady mechanical revenues even as the revenues of the industry that pays those royalties—the recording industry—have dropped dramatically due to falling sales and falling prices. To try to accomplish that feat, the Copyright Owners are forced to deny reality. Even as the record industry continues to struggle to an unprecedented degree to keep its head above water, they ask this Court to find that the industry is "thriving," CO PFF ¶ 31, and in a "healthy financial state" after just a brief period of restructuring, CO PFF ¶ 30, while

publishers are suffering and songwriters are leaving the business in droves. This portrayal of the record is preposterous.

30. As the Copyright Owners acknowledge, the major U.S. record companies cut more than half their employees from 2001 to 2005. CO PFF ¶ 401. Their revenues from CD sales dropped from $5.3 billion in 1999 to $3.8 billion in 2006, CO PFF ¶ 403, and 2007 was worse yet, RIAA Trial Exs. 66 & 67. While the industry has shown operating profits on its books in most years, that is only because the majors have taken restructuring charges—larger than all of those profits—that as an accounting matter do not show up as affecting their reported profits. 2/6/08 Tr. 1879:3-1880:21 (H. Murphy). And there is every reason to expect that revenues will continue to shrink going forward, and restructurings will continue to be a regular event. *See* RIAA Trial Ex. 27 at 1 (Enders report from March 2007 predicting continued worldwide reduction of recorded music sales through 2012). As a result, there is a serious question whether the recording industry, in its current form, can survive.

31. The Copyright Owners nevertheless suggest that the shift to digital delivery will save the industry and deliver higher profit margins as a result of the elimination of manufacturing and physical distribution costs. But while they discuss the growth in digital revenues, and claim that this is the reason why the industry is showing profits on its books, they never acknowledge that (1) CDs remain the dominant medium, and (2) in any event, downloads are only slightly more profitable under current prices than CDs, and they may soon become unprofitable altogether. Benson WRT at 4-6, RIAA Trial Ex. 82.

32. At the same time, while it is obvious that piracy and the resulting drop in unit sales of recordings have hurt publishers and songwriters by reducing mechanical royalties that otherwise would have been paid, the Copyright Owners' portrayal of those effects is grossly

exaggerated. They go so far as to say that "[s]ongwriters and music publishers have been *particularly* hard hit by the loss of revenue attributable to piracy," CO PFF ¶ 348 (emphasis added), but the record makes clear that songwriters and publishers have been substantially, if not completely, shielded from harm, for two reasons.

33. First, the steady increases in the mechanical royalty rate, negotiated in 1997 when everyone foresaw only prosperity ahead, have compensated for lost sales volume. This has allowed publishers' mechanical royalty revenues industry-wide to hold steady even as the sales and prices of recordings have been dropping precipitously. RIAA Trial Ex. 27 at 34 (Enders March 2007 report). The Copyright Owners make only the weakest of efforts to rebut this fact which is supported by their own expert's report. In attempting to do so, they rely on the mechanical revenues of the Harry Fox Agency or of individual publishing companies, without any effort to aggregate these figures to eliminate the effects of market share variations, *see* CO PFF ¶ 343 (citing HFA, Famous and EMI); *but see* CO PFF ¶ 263 (acknowledging UMPG mechanical revenues have increased faster than inflation rate).[6]

34. As a result, the share of record company revenues devoted to paying mechanical royalties is higher now than ever before. Teece WDT at 28-29, RIAA Trial Ex. 64. That fact by itself argues forcefully for a reduction to restore the balance between the earnings of the Copyright Owners and those of the Copyright Users.

35. One of the Copyright Owners' economists, Kevin Murphy, argued that it was irrelevant that publishers and songwriters are already receiving a much larger slice of the pie

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[6] Typical of the Copyright Owners' discussion of the evidence is their claim that Dr. Teece "agreed that mechanical royalty income is declining on both a nominal and real dollar basis." CO PFF ¶ 12 (citing Teece WDT at 59, RIAA Trial Ex. 64). In fact, on the page cited, Dr. Teece said that "[o]ther than for 2000, mechanical royalty payments to the publishers in 2005 were at an all-time high," having increased every year from 2001-05. Teece WDT at 59, RIAA Trial Ex. 64.

than ever before. He claimed that one should not expect a constant relationship between what record companies are paid for recordings and the mechanical royalty rate. CO PFF ¶ 729 ("'[a] benchmark based on a fixed ratio between the price paid to an input (songwriters) and the price of the output (recorded music) . . . is not an appropriate indicator of market values'" under conditions of falling sales and prices of CDs) (quoting K. Murphy WRT at 6, CO Trial Ex. 40). But the primary economic expert for those same Copyright Owners, William Landes, based his entire benchmark analysis on the proposition that the market establishes a relative valuation of sound recordings and musical works that should be consistent not only over time but from product to product. *See* CO PFF ¶ 488 (summarizing Landes's approach) ("[A]n appropriate benchmark provides information regarding the *relative* valuation of the musical composition and sound recording when both rights are free from the constraint of a compulsory license") (emphasis in original).

36. The Copyright Owners' case is thus built on a fundamental internal contradiction. In order to come up with some kind of argument favoring an increase in mechanical rates, Dr. Landes was forced to claim that there should be a consistent relationship between wholesale prices of recordings and mechanical royalties paid for those recordings across all products and over time. But that principle leads inexorably to the conclusion that rates for CDs and digital downloads are already too high. So the Copyright Owners then called Dr. Murphy to advise the Court to ignore the relationship between wholesale price and mechanical rates. That testimony, if accepted, would undercut the entirety of Dr. Landes's benchmark analysis. Of course, both Dr. Murphy and Dr. Landes are wrong: Dr. Murphy because he misapplies fundamental principles when he argues that the mechanical rate should not decline even though demand for sound recordings and songs has fallen; and Dr. Landes because ringtones have such different

purposes and supply and demand characteristics than CDs and digital downloads that the former cannot serve as a basis for setting rates for the latter.

37. A second reason publishers and songwriters have been less affected by piracy is that they are much less dependent than the record companies on revenues arising directly out of sales of recorded music. They also receive substantial and growing revenues from other sources like performance royalties, which are derivative of prior sales of recordings. *See* RIAA PFF Sections II.E.2.a-e.

38. The evidence makes clear the effects of these dual protections on the economic circumstances of the songwriters. The average songwriter's mechanical royalty income has increased by 10% above and beyond the rate of inflation since 2003, and the average songwriter total royalty income has increased 15% above and beyond the rate of inflation during the same period. 5/20/08 Tr. 7288:13-7290:1 (Landes). And these figures do not take into account monies received by songwriters in the form of unrecouped advances, which the Copyright Owners claim are substantial, CO PFF ¶ 316, but which Professor Landes neglected to study. 5/20/08 Tr. 7327:10-21 (Landes).

39. Another result is that the publishers have not skipped a beat in raking in consistent profits, often in the 25-30% range. Santisi WRT at 44, RIAA Trial Ex. 78. Notably, for all their discussion of the record companies' supposedly burgeoning profits, the Copyright Owners never once discuss the music publishers' profitability, let alone acknowledge that publishers continue to earn extraordinary profits.

40. Given these economic circumstances—falling demand for the finished consumer product causing falling prices and falling revenues for the record companies—it only makes sense to conclude that in a free market the per-unit value of an input for that finished product

would also fall as well. Slottje WRT at 14-15, RIAA Trial Ex. 81. The Copyright Owners found one economist who would say the opposite, Kevin Murphy. But his analysis is utterly unpersuasive because it ignores many relevant facts.

41. First, he assumes that the price reduction for recordings is a result of reduction in other costs—*i.e.*, manufacturing and distribution. But the price reductions are for CDs, and those costs have not disappeared at all for CDs. Second, he seems to assume that songwriters have substantial fixed costs that have to be recovered. But there was never any coherent explanation of what those are. Finally, he said that the market would respond to smaller unit sales by increasing the price paid per unit to songwriters in order to maintain adequate incentives to produce songs. But that ignores the reality of what makes songwriters produce songs.

42. The evidence makes clear several things about songwriter incentives. To begin with, they are currently more than adequate. There are vastly more songs being written than are being recorded. Faxon WDT at ¶ 42, CO Trial Ex. 3 ("Each year, hundreds of thousands of people attempt to write songs," but "[o]f the songs that are written, very few ever will be published, and very few of the published songs ever will become successful recordings.").

43. Moreover, economists for both the Copyright Owners and RIAA agreed that the primary incentive for songwriters is not what the average songwriter earns but the prospect of becoming one of the truly successful and quite wealthy songwriter elite. 5/20/08 Tr. 7344:7-7345:21 (Landes); Slottje WRT at 24-25, RIAA Trial Ex. 81. That prospect combines with the noneconomic factors motivating people to want to be songwriters, as outlined by hedonic wage theory. Slottje WRT at 22-24, RIAA Trial Ex. 81. The elite are already earning millions of dollars a year and would continue to do so even if rates are reduced. The market would therefore

have no reason to raise the royalty rate, in the face of falling unit sales, in order to maintain incentives.

44. Finally, most successful songwriters are singer-songwriters. 1/29/08 Tr. 498:19-499:8 (Faxon). Most of what they record they have written themselves. Indeed, the system is designed to assure that the large majority of songs being recorded are written by singer-songwriters and recorded on their own new albums. *See* Faxon WRT at Ex. K at ¶¶ 4.01-5.05, CO Trial Ex. 375 (singer-songwriter agreement with publisher specifying that most of the songs on a qualifying album must be new compositions by the singer-songwriter); 1/29/08 Tr. 479:2-7 (Faxon) (suggesting that all 700 of their current contracts have similar structure). That is an added reason why it is nonsensical to be concerned that a reduction in the mechanical rate will unduly reduce incentives to produce quality songs. An artist who wants a record company to produce a recording will certainly remain motivated to write the requisite songs, and will continue to make every effort to make those songs as good as possible in order to make the album project successful.

45. The Copyright Owners attempt to buttress their case by trumpeting the supposedly high risks they take and important contributions they make in the process of producing and selling sound recordings. But it is perfectly obvious where most of the risk-taking occurs in the production of songs and sound recordings: it is incurred by the record companies that provide the vast majority of the investment and do the vast majority of the work.

46. By comparison, calling the songwriting profession risky is inherently misleading. Obviously, most songwriters are unsuccessful because this is an industry with very low barriers to entry, lots of reasons why people want to participate, and a limited number of opportunities for success in the form of high-selling recordings. But raising the rate is not going to change that

reality in the slightest. Indeed, as Dr. Landes conceded, raised rates might largely be dissipated among a larger number of sellers if they encourage even more entry into the profession. 5/20/08 Tr. 7287:9-14 (Landes).

47. Moreover, the publishers largely mitigate the riskiness of songwriting for those who are sufficiently successful to have publishing contracts. Advances guarantee predictable and substantial incomes for this group of songwriters, regardless of whether their songs are successful. *See* RIAA RPFF Section V.C.3. But Dr. Landes, in his calculations supposedly comparing the riskiness of songwriting with the riskiness of running a record company in the current environment, simply ignored advances since they were not in the songwriter-income data he analyzed. Landes WRT at 12-13, CO Trial Ex. 406; 5/20/08 Tr. 7327:10-15 (Landes).

48. As for the claimed riskiness of publishers, numerous documents in the record make clear that this industry is anything but. A publisher primarily owns a large catalog of compositions, the value of which is predictable and safe. 2/12/08 Tr. 2695:9-2696:10 (Firth) (agreeing with the statement that music publishing is a "[h]ighly profitable business model with high margin annuity-like cash flow generation"). Very little is invested to create new compositions, and A&R costs are close to trivial in comparison with those of the record companies. *See* RIAA PFF Sections II.E.2.b, d, & e.

49. Advances in the aggregate are also small by comparison. Moreover, the publishers recoup the vast majority of those advances. The Copyright Owners claim that 50% of advances are never recouped, but the record does not remotely support that claim.

50. Ultimately, the argument that the Court needs to raise the rate to reflect the risks associated with songwriting and publishing is as unsupported and illogical as the notion that a higher rate is needed to provide incentives for increased production of songs when the market is

already flooded with songs. What would really benefit the songwriters, the publishers and the public is a lower rate that can allow greater production of the sound recordings that the public wants and that provide the income to all participants in the chain of production.

C. A Percentage Rate Structure Is Appropriate.

51. Finally, the Copyright Owners argue that this Court should adopt a cents rate royalty structure like the one implemented in Section 115 when piano rolls were the dominant product configuration. This is yet another fundamental contradiction in the Copyright Owners' position. The cornerstone of their case is Dr. Landes's testimony that there should be a consistent relationship between wholesale prices of recordings and mechanical royalties paid for those recordings, across product configurations and over time. However, the principal advantage they cite for a cents rate structure is that they are paid the same regardless how their works are used. Because many different types of uses are covered by Section 115, even within a category such as downloads, and per-track wholesale prices vary widely and are likely to change over time, a single cents rate cannot scale in a way that is proportional to the market value of the use as reflected in the wholesale price of the sound recording and the units sold.

52. This Court's decisions in the webcasting and SDARS cases teach that the royalty rate should reflect the value of the usage. Here, achieving that objective demands a percentage rate. A percentage rate based on record company wholesale revenues—the same basis that record companies use to pay artists, producers, unions and, in the case of ringtones, music publishers—is readily administrable and will provide pricing flexibility, allow record companies to make more music available to the public, and ensure that Section 115 does not thwart new types of product and service offerings.

II. THE COPYRIGHT OWNERS' ATTACKS ON RIAA'S BENCHMARKS AND CORROBORATING EVIDENCE FAIL.

A. Dr. Wildman's Use of Actual Rates Negotiated in the Marketplace for Mechanical Licenses on CDs Provides the Best Benchmark on Which to Evaluate the Market Value of the Rights at Issue.

53. As discussed in detail in RIAA PFF Section III, Dr. Wildman, a highly qualified expert in media economics who has analyzed the music industry throughout his career, concluded that the best benchmarks the Court could use in setting rates for CDs and digital downloads are voluntary deals for mechanical rights to produce sound recordings of songs, negotiated in the marketplace between record companies and the Copyright Owners. Dr. Wildman examined a large amount of data from three different record companies and two music publishers and presented the Court with three measures: (a) the average effective rate across all mechanical licenses for CDs; (b) the average effective rate for first uses of musical works which are not subject to the compulsory license; and (c) the average effective rate for first uses of musical works negotiated by songwriters who are not parties to controlled composition clauses in recording or producing contracts. *See* Wildman WRT at 37-44, RIAA Trial Ex. 87; CO Trial Exs. 313-16 (summaries of Wildman analyses showing averages calculated on a per track basis). As Dr. Wildman explained, each of these measures provides useful information to the Court concerning the appropriate rate to be set in this proceeding.

54. The Copyright Owners level a number of criticisms at Dr. Wildman, but none erode the basic point of his testimony—in the free market, in the absence of a statutory license, there would remain, as there is today, tremendous competition for songwriters to get songs onto albums, and the rates that would be negotiated would therefore be far less than the current statutory rate.

55. Indeed, songwriter after songwriter testified not only that record companies and recording artists have their pick of songs and demand lower rates in order to get an song onto an album, 1/28/08 Tr. 208:7-11 (Carnes); 1/30/08 Tr. 829:21-830:2 (Shaw); Shaw WDT at 5, CO Trial Ex. 5, but also that this aspect of the market is only becoming more pronounced as there are fewer and fewer opportunities for songs to be recorded, regardless of the total number of songs that are written. 1/28/08 Tr. 262:1-10 (Bogard). Mr. Galdston identified the decreasing number of record labels as "problematic for songwriters" because there are fewer spots on albums for outside songwriters meaning fewer opportunities to turn songs into sound recordings. Galdston WDT at 7, CO Trial Ex. 4.

1. The Copyright Owners' Criticism That Dr. Wildman's Benchmarks Are Not Useful Because They Are Not Wholly Independent of the Statutory Rate Is Not Valid.

56. The Copyright Owners' principal attack on Dr. Wildman is the claim that the Court cannot consider rates actually negotiated in the marketplace because the statutory rate operates as a ceiling on what the Copyright Owners can obtain in the marketplace and because rates negotiated in the marketplace are not independent of the statutory rate itself. CO PFF Sections XIII & XV.B.3.a.i. Those arguments fail to undermine Dr. Wildman's analysis, because they exaggerate and distort the actual interaction between the statutory rate and the voluntary deals Dr. Wildman studied. In reality, the effect of the statutory rate is to *raise*, rather than lower, the average rates voluntarily negotiated in the marketplace.

a. In the Current Marketplace, the Statutory Rate Does Not Operate as a Cap—It Essentially Does Not Operate at All.

57. The Copyright Owners assert that the statutory rate operates as a cap on the rate that the Copyright Owners can receive, but that claim is inconsistent with the marketplace evidence. It depends entirely on the assumption that the compulsory license process spelled out

in the regulations is a realistic and regularly used alternative to a voluntary deal, thus limiting what record companies would voluntarily agree to pay to the statutory rate. As discussed in RIAA PFF ¶¶ 618-627, the evidence demonstrates precisely the contrary. The compulsory license is simply not an option for record companies to use on a regular basis because of its significant administrative burdens and transaction costs. RIAA PFF ¶ 610. Indeed, it is conceded by all parties that the compulsory license is virtually never used. As a result, the behavior that one sees in the marketplace—a complete absence of voluntary deals even a little above the statutory rate—cannot be a function of the compulsory license acting as a cap.

58. The Copyright Owners suggest that Dr. Wildman conceded that the statutory rate acts as a cap on what they can receive, but that distorts his testimony. CO PFF ¶ 560. Rather, Dr. Wildman explained that the cap on what the Copyright Owners can receive is the statutory rate plus the transaction costs of using the compulsory license—transaction costs that the record demonstrates are so high that no one uses it. Wildman WRT at 33, RIAA Trial Ex. 87.

59. There are, however, no voluntary deals above the statutory rate but below the level equal to the statutory rate plus the transaction costs of using the compulsory license. As the record shows and Dr. Wildman found, there are many voluntary licenses at the statutory rate because parties can license through HFA at that rate with little to no transaction costs. RIAA PFF ¶¶ 612-618; 5/12/08 Tr. 5827:13-5829:8 (Wildman). Where parties actually negotiate, however, and incur transaction costs, however, parties agree to royalty rates far below the current statutory rate. This caused Dr. Wildman to conclude that, rather than placing a cap on the rates that would otherwise be negotiated, the effect of the current statutory rate is to pull up the average royalty rate. RIAA PFF ¶¶ 612-618. It follows that in the hypothetical marketplace that must serve as this Court's benchmark, where the transaction costs of negotiating would be

unavoidable for every license, the parties would agree to royalty rates far lower than the current statutory rate and also lower than the current average rate in voluntary deals.

60. As Dr. Wildman testified, when record companies engage in negotiations over musical works rights and cannot avoid transaction costs—for example, in the context of negotiations with recording artists over recording contracts with controlled composition clauses and in negotiations with music publishers over first uses of musical works which are not subject to the compulsory license—the royalty rates are significantly lower than the current statutory rate. RIAA PFF ¶ 619; 5/12/08 Tr. 5829:9-20 (Wildman) (explaining that he saw no basis for viewing the current rate as a "ceiling").

b. The Claim That the Statutory Rate Is Interrelated with the Rates Seen in the Marketplace Does Not Undermine Dr. Wildman's Analysis.

61. The Copyright Owners argue that the actual rates negotiated in the marketplace must be wholly ignored by the Court because they are "interrelated" with the current statutory rate. CO PFF Section XV.B.3.a.i. The Copyright Owners go so far as to argue that, as a matter of law, the Court cannot consider real market transactions for the products at issue before this Court. CO COL Section III.D. As explained in detail in RIAA's Reply Proposed Conclusions of Law, the Copyright Owners' legal arguments fly in the face of the express language of Section 115 and prior copyright royalty decisions indicating that the Court may consider transactions concluded for rights otherwise subject to the statutory license. RIAA RCOL Section II.A.

62. The voluntary deals studied by Dr. Wildman are precisely the sort of transactions that Congress anticipated this Court using as benchmarks. Section 115 itself specifically explains that "[i]n addition the objectives set forth in section 801(b)(1), in establishing such rates and terms, the Copyright Royalty Judges may consider rates and terms under voluntary license

agreements described in subparagraph (B) and (C) [the provisions authorizing negotiation of voluntary agreements]." 17 U.S.C. § 115(c)(3)(D). Thus, Congress specifically authorized this Court to consider voluntary licenses actually negotiated in the marketplace governing the very activities that are the subject of this proceeding.

63. Indeed, this proceeding is particularly susceptible to such a benchmark analysis because the compulsory license does not operate in the current marketplace, leaving the parties to negotiate licenses at whatever rate is compelled by the market circumstances. That parties may find the statutory rate a convenient focal point on which to premise rates does not mean that the rates negotiated are not sufficiently independent to be used as benchmarks; after all, parties do settle on a rate and know precisely what they are paying and being paid. Dr. Wildman found that there was a thriving market for voluntary licenses. Wildman WRT at 31, RIAA Trial Ex. 87. And the primary effect of the statutory rate on the operations of that market would be to raise the average rates negotiated, leaving the Copyright Owners no basis for complaint.

64. Even if viewed as imperfect because of the influence of the statutory rate, Dr. Wildman's analysis remains the best benchmark before this Court. Dr. Wildman presented the Court with three different measures, with each succeeding measure less influenced by the statutory rate. The average effective rate was based on all transactions in the marketplace. Wildman WRT at 36-40, RIAA Trial Ex. 87. His second measure focused only on the subset of licenses for first uses of musical works, which are not subject to the compulsory rate and thus not directly dependent on the statutory rate at all. Wildman WRT at 40-42, RIAA Trial Ex. 87. His third measure focused only on the subset of licenses for first uses of musical works that were negotiated by pure songwriters who have not negotiated a recording contract with a controlled composition clause and are free to negotiate any rate they want to license a new song or even to

write a new song. RIAA PFF ¶¶ 635-658. This third category is both not directly dependent on the statutory rate and not directly dependent on controlled composition clauses (discussed below). RIAA PFF ¶ 654; A. Finkelstein WDT at 8, RIAA Trial Ex. 61 (discussing licensing co-writer shares individually); 2/14/08 Tr. 3393:2-10 (A. Finkelstein) (same).

65. As Dr. Wildman explained, the influence of the statutory rate is far less for first uses than for licenses theoretically covered by the compulsory license. For first uses, which must be negotiated individually, Wildman WRT at 32-33, RIAA Trial Ex. 87, the option to avoid transaction costs by using the streamlined HFA process does not exist. As Dr. Wildman explained, first use rates may be influenced by the rates for second uses to a limited extent because each use competes with the other. CO PFF ¶ 71; 5/12/08 Tr. 5825:11-5826:21 (Wildman). But since rates for second uses are dragged *up* as a result of the existence of a statutory rate and the desirability of avoiding transaction costs by licensing at the statutory rate through HFA, competition between first uses and second uses is not going to make first use rates artificially low.

66. To counter Dr. Wildman's examination of the evidence, the Copyright Owners ignore most of the record and rely on a few pieces of discredited evidence. First, the Copyright Owners continue to argue that the statutory rate is operating as a ceiling based on Dr. Landes's study of the rate of discounting using the HFA data. CO PFF ¶¶ 569-576. But as a threshold matter, this criticism does not apply to Dr. Wildman's second and third benchmarks relating to first use licenses, which Dr. Landes did not separately analyze. Moreover, critical to Dr. Landes's analysis was the conclusion that the rate of discounting has been *declining* in recent years, but that conclusion does not stand up to scrutiny.

67. As detailed in Mr. Alfaro's testimony, RIAA PFF ¶¶ 1067-1078, if one corrects Dr. Landes's study either by including the small number of controlled licenses in the HFA database or by including the 700,000 licenses in the database that have notations like "negotiated" or "reduced," one finds that the rate of discounting has actually been *increasing* in recent years. Indeed, the prevalence of increasingly aggressive discounting pressure in the face of the increasing statutory rate was a complaint of numerous songwriter and music publisher fact witnesses. *See* RIAA PFF Section IV.F; CO PFF ¶¶ 241-250.

68. Second, Dr. Landes argues that transaction costs for negotiating below the statutory license are low and uses this factual assertion to conclude that the existence of many licenses at the statutory rate shows that the statutory rate is holding down free market rates. CO PFF ¶¶ 565-566. But the key fact on which Dr. Landes relies—that transaction costs for negotiating below the statutory license are low—is simply not true. As explained in RIAA PFF ¶¶ 1086-1098, numerous witnesses with direct knowledge and experience have testified about the significant burdens of trying to negotiate reduced rate licenses, particularly in light of the fact that few sound recordings sell a sufficient number of copies to compensate for the transaction costs. To counter this evidence, the Copyright Owners provide absolutely no testimony from anyone who actually works in the industry, citing only to Dr. Landes's assertions and to no fact testimony at all. CO PFF ¶¶ 565-566.

69. Indeed, Dr. Landes's sole support for his conclusion that transaction costs are low is that HFA serves as one-stop shopping for mechanical licensing. CO PFF ¶¶ 565-566. But as the record demonstrates, RIAA PFF ¶ 83, HFA does not represent all publishers and is not authorized to agree to rates below the statutory rate for CDs and digital downloads; HFA can only issue licenses at the statutory rate or forward requests for reduced rates to individual

publishers, serving not as a clearinghouse but as an increasingly unnecessary middleman that only increases transaction costs. Dr. Landes's conclusions are thus premised on a wholly inaccurate understanding of his clients' own operations.

70. As the record also shows, transaction costs are sufficiently high that one would expect—as is true—that record companies only ever bother to attempt to negotiate lower rates for sound recordings that are likely to sell in high volumes (as Andrea Finkelstein testified was the SONY BMG policy), RIAA PFF ¶ 1095, or where negotiations must occur for some other reason (first uses and recording contracts). Otherwise, the transaction costs simply swamp any benefit to be obtained from a reduced rate.

2. The Existence of Controlled Composition Clauses Supports a Rate Reduction and Is Not a Basis on Which to Reject Dr. Wildman's Analysis.

71. The Copyright Owners' second criticism of Dr. Wildman's analysis is that his analysis of the overall effective mechanical rate and his analysis of the average rate paid for first uses include some licenses granted as part of a controlled composition clause in a recording or producing contract. The argument is that the terms of such clauses are unduly affected by the presence of other terms of these agreements. CO PFF ¶ 686. The existence of controlled composition clauses does not, however, sully these two benchmarks analyzed by Dr. Wildman and is not even implicated by Dr. Wildman's third benchmark, which focuses on songwriters who are not subject to a controlled composition clause in a recording contract.

72. In its Proposed Findings of Fact, RIAA addressed these arguments in detail, citing the voluminous factual record that refutes the Copyright Owners' claims. RIAA PFF ¶¶ 638-644. In addition to that discussion, RIAA notes the following problems with the Copyright Owners' dismissal of Dr. Wildman's analysis.

73. First, the average effective rate and the average first use rate show what every songwriter and music publisher is willing to accept as mechanical royalties. Both calculations reflect the royalty rates to which songwriters and music publishers agree daily in the marketplace —songwriters for writing songs and music publishers for providing administrative services in exchange for a portion of the royalties. As discussed in RIAA PFF ¶ 606, it is not just that music publishers accept these rates—they actually pay the largest advances to singer-songwriters who are subject to controlled composition clauses. If those rates did not provide a sufficient return, the Copyright Owners would not agree to them.

74. Second, consistent with this Court's prior decisions, the hypothetical market in this proceeding is one in which a record company is negotiating with a songwriter or music publisher for a mechanical license to a single copyrighted work to be made into a sound recording to be listened to (in the case of a CD or digital download) or a sound recording to be used as a cellphone accessory (in the case of a mastertone). In the absence of a compulsory license, controlled composition clauses would remain a "marketplace reality." 1/28/08 Tr. 217:9-218:1 (Carnes). The Copyright Owners' argument that controlled composition clauses must be wholly ignored is simply an effort to posit a different hypothetical market than the one that would exist in the absence of Section 115.

75. Third, the Copyright Owners' argument that recording agreements reflect trade-offs (and thus that the rates in controlled composition clauses represent negotiated discounts in exchange for concessions in other parts of the license), CO PFF ¶¶ 686-689, is inconsistent with the Copyright Owners' own claim that controlled composition clauses are standard in the industry and hardly ever negotiated. David Israelite, for example, testified that "it's fairly common to hear from artist and artists' representatives that there's not much of a negotiation at

all" over controlled composition clauses. 2/5/08 Tr. 1450:14-16 (Israelite). Multiple witnesses have testified about the standard terms of controlled composition clauses under which singer-songwriters agree to receive 75% of the current statutory rate. The evidence also demonstrates that this current standard of 75% of the current 9.1 cents rate has reached this point because, as the statutory rate has increased, record companies increasingly demanded greater reductions off the increasing statutory rate. RIAA PFF ¶ 597.

76. This last point emphasizes why recording contracts are different from NDMAs. The Copyright Owners' own evidence shows that songwriters and music publishers accept less for mechanical royalties because that is simply what they must do in order to get record companies to make the enormous investment that they do to transform notes and lyrics into sound recordings that have a chance for commercial success. There is no trade-off for other concessions—rather, a rate that is 75% of the current statutory rate with a cap on the number of songs per album is the going rate for new contracts for mechanical royalties. RIAA PFF Section III.B.3.

77. Moreover, even if there were trade-offs, Dr. Wildman's analysis would have accounted for them. Given the very large number of transactions that he reviewed, the sole conclusion that can be drawn is that the average effective mechanical rate represents the mechanical rate songwriters are willing to accept in exchange for the industry standard in terms of contribution, investment, and risk undertaken by the record companies. Wildman WRT at 39-40, RIAA Trial Ex. 87. To the extent that there were trade-offs that might have been made in any particular recording contract, one would expect that there would be some in which songwriters trade off higher mechanical royalties for a lower advance and vice-versa, meaning that the average across thousands of transactions would wash away these issues.

78. Indeed, even if the Court agreed with the Copyright Owners that royalty rates accepted by singer-songwriters and music publishers as part of controlled composition clauses should not be considered in this proceeding because such rates involve trade-offs, that logic compels the conclusion that the Court should ignore that other types of consideration in the NDMAs, including the mastertone benchmark proffered by the Copyright Owners. And if one believes that the NDMAs and rates from the ringtone agreements on which the Copyright Owners rely are a good benchmark for mastertone rates, then one must also conclude that the rates in controlled composition clauses are good benchmarks for CDs and digital downloads.

79. The Copyright Owners also criticize Dr. Wildman's analysis of the average effective rate and the average first use rate because the rates specified in controlled composition clauses have often been expressed as a percentage of the statutory rate. That provides no basis for rejecting Dr. Wildman's analysis.

80. First, regardless of how the rate is to be calculated, a singer-songwriter and a music publisher know precisely what they are agreeing to. That the parties use the statutory rate as a convenient reference point does not mean that they did not agree about the rate to be paid and potential adjustments thereto (such as through an album cap). If 75% of the current statutory rate was too low, songwriters would not agree to it. That they do agree to such rates in droves is highly instructive. RIAA PFF Section III.B.3.

81. Second, the Copyright Owners point to an "empirical" study that Dr. Murphy purports to have done concerning controlled composition clauses in recent years, concluding that controlled composition clauses have not changed much as the statutory rate has increased. CO PFF ¶ 692. But that study is wholly unsound as an empirical matter and provides no basis for drawing any conclusions at all.

82. Dr. Murphy had access to recording agreements going back five decades, but based his analysis on only 27 agreements from a single record company (EMI), dating from 1999 to 2006. Murphy WRT at 14-15 & Ex. B, CO Trial Ex. 400. He did not suggest that this sample is representative or statistically valid in any way, nor could he. Indeed, of the 27 agreements, 9 are for artists on Christian music labels (Sparrow Records, Forefront Records, Tooth and Nail, and EMI Christian Music Group) and another 7 are for jazz record labels (Blue Note and High Octave Music) —amply demonstrating that his sample was not representative of anything.

83. Although Dr. Murphy purported to analyze the *changes* in controlled composition clauses from 1999 to the present, he looked at only one recording contract from 1999—from a Christian Music Label—and no recording contracts from 2000. Murphy WRT at Ex. B, CO Trial Ex. 400. Similarly, he looked at only 1 recording contract in 2002. Murphy WRT at Ex. B, CO Trial Ex. 400. Indeed, fully 16 of the 27 contracts were entered into in 2004 or later, when record companies knew that they were on the verge of the statutory rate increasing to 9.1 cents. Murphy WRT at Ex. B, CO Trial Ex. 400. Given this sample, there is no way that Dr. Murphy could draw conclusions about trends in controlled composition clauses over time. Indeed, all his study shows is that record companies today demand—and generally receive—a royalty rate of 75% of 9.1 cents (*i.e.*, 6.825 cents), which can be further reduced by operation of an album cap.

84. In addition, Dr. Murphy's unsupported conclusions are directly contradicted by the testimony of multiple of the Copyright Owners' fact witnesses with actual knowledge of the industry. As the Court is aware, Dr. Murphy had little prior experience with the music industry and knew nothing about recording contracts prior to undertaking his "study." As discussed in RIAA PFF ¶ 597, the Copyright Owners themselves have insisted that as the statutory rate has

increased, record companies have increased their demands for controlled composition clauses—and this is precisely because the statutory rate has become unacceptably high.

85. Fourth, in drawing his conclusion that controlled composition clauses have not changed as the mechanical rate has gone up, Dr. Murphy relied on Dr. Landes's original conclusion that the amount of discounting from the statutory rate was on the decline. 5/15/08 Tr. 6907:22-6908:10 (K. Murphy). But as noted in RIAA PFF ¶¶ 1067-1078 and RIAA Reply PFF Section VI.C, Dr. Landes only produced that conclusion by excluding controlled licenses, as well as 700,000 other discounted licenses. The reality is that the HFA data show discounting actually *increasing* in recent years. Dr. Murphy's conclusions thus cannot be relied upon.

86. Finally, the Copyright Owners' criticism about controlled composition clauses simply has no applicability to Dr. Wildman's third benchmark—the rates that pure songwriters who are not parties to a recording agreement negotiate in the marketplace. The Copyright Owners argue that the rates to which pure songwriters agree are somehow tainted by controlled composition clauses, but that argument is unpersuasive. As songwriter witness after songwriter witness testified, they routinely agree to be bound by terms similar to the controlled composition clauses to which their co-writers have agreed, or they agree to other discounted rates. Wildman WRT at 14, RIAA Trial Ex. 87; 1/30/08 Tr. 829:20-830:13 (Shaw); 1/28/08 Tr. 208:7-11, 211:12-212:4 (Carnes); Shaw WDT at 5, CO Trial Ex. 5; 1/30/08 Tr. 796:14-797:4 (Galdston); 1/30/08 Tr. 829:21-830:2 (Shaw). They are unquestionably free to reject such rates, but they accept them precisely because that is how the marketplace values their efforts. That songwriters "must" accept such rates is not a reflection of improper market power by the record companies or anything other than the marketplace itself—it simply reflects the fact that there are many songs and few recordings— indeed far fewer recordings today than there have been in recent memory.

1/28/08 Tr. 262:1-22 (Bogard) (describing how there are half as many recordings as there used to be); Galdston WDT at 7, CO Trial Ex. 4.

3. First Use Licenses Accepted by Pure Songwriters Are a Good Benchmark for Setting Rates in this Proceeding.

87. Because they are not directly affected by controlled composition clauses and are not subject to the compulsory license, first-use licenses agreed to by pure songwriters are arguably the most informative of Dr. Wildman's three benchmarks. Beyond pointing unpersuasively to indirect influence exercised by the statutory rate and controlled composition clauses (critiques answered above), the Copyright Owners resort to suggesting that some of the co-writers included in Dr. Wildman's analysis may have received "additional remuneration, such as advances, in exchange for their agreement to take reduced rates." CO PFF ¶ 705.

88. Other than eliciting Dr. Wildman's testimony that this was theoretically possible, the Copyright Owners offered not a shred of evidence that such additional remuneration was paid to any co-writers during this time period, let alone evidence of the prevalence or magnitude of such remuneration. Indeed, none of the songwriter witnesses testified that such payments occurred, and when asked, the President of the Songwriters Guild suggested that such payments were unlikely to occur. 1/28/08 Tr. 211:15-212:4 (Carnes) ("The artist isn't going to do that [pay a songwriter out of his or her own pocket]."). Moreover, to the extent they are talking about advances (the only example of indirect remuneration of co-writers cited in the Copyright Owners' Proposed Findings of Fact), their own expert has taken the position that advances to songwriters should not be included in a study of songwriter income, 5/20/08 Tr. 7327:10-22 (Landes), presumably because they are loans subject to repayment through recoupment.

89. The Copyright Owners also suggest that first uses are somehow different because songwriters have an incentive to get songs out into the marketplace. CO PFF ¶ 698. The

premise of this argument is that songwriters have an incentive to get songs recorded for the first time at the low rate in the hopes that they will earn other revenues from subsequent uses. Initially, the Court should note that this argument blatantly conflicts with the Written Direct Testimony of the Copyright Owners' expert, William Landes. Indeed, in Dr. Landes's direct testimony, he openly acknowledged the value of first uses as compared with older songs, stating that "much of the music that is sold is newly created," that "[a] substantial fraction of the use of music is of 'hits' that have been recently created," and that "[t]he existing stock of music often *is not a good substitute* for new creations." Landes WDT at 26, CO Trial Ex. 22 (emphasis added).

90. Moreover, to the extent these subsequent uses are performance or synchronization revenues, songwriters have the same incentives to get a song recorded whether it is a first use or a second use. To the extent that these subsequent uses are mechanical licenses from subsequent recordings (*i.e.*, second uses), it is absurd to believe that songwriters license the first time a recording on the cheap, hoping for better results the second time it is recorded. As the record shows, only a tiny fraction of sound recordings are even minimally successful, Teece WDT at 95, RIAA Trial Ex. 64 (noting that only 3% of CDs sell more than 5,000 copies and only 250 of the 32,000 CDs released in a year sell more than 10,000 copies), and there is no guarantee that a song will ever be recorded a second time. As Mr. Carnes testified, it is difficult to get a song that has been previously recorded by some one to be re-recorded by another artist, 1/28/08 Tr. 219:11-220:21 (Carnes), and where the same artist re-records a song, songwriters often must agree to accept a lower and lower rate with each successive re-recording. 1/28/08 Tr. 201:3-11 (Carnes) (discussing how with each successive re-recording, the rate negotiated is often lower).

91. As the record shows, the average rate paid for first uses, whether to all songwriters (Dr. Wildman's second benchmark) or to just the subset of pure songwriters (Dr.

Wildman's third benchmark), almost certainly overstates the fair market value of second uses. As Dr. Wildman found, hit songs are almost always first uses. Wildman WRT at 42, RIAA Trial Ex. 87.

92. In the end, Dr. Wildman had a strong basis for concluding that first use licenses provided a good benchmark for the rates to be set in this proceeding. First uses licenses are for products wholly comparable in the market, are not subject to the compulsory license, are likely more valuable than second uses, and require negotiation in the marketplace, thereby simulating the very hypothetical market that this Court must replicate. 5/12/08 Tr. 5834:8-5837:22 (Wildman).

4. The Copyright Owners' Criticisms of Dr. Wildman's Empirical Work Are Insubstantial.

93. The Copyright Owners argue that Dr. Wildman's analysis should be given no weight because of claimed flaws in his empirical work, CO PFF ¶¶ 699-706, but those arguments are without merit.

94. As a threshold matter, the Copyright Owners' attacks on Dr. Wildman's work pale in comparison to the demonstrated and highly prejudicial errors in the empirical work of the Copyright Owners' experts. Ms. Helen Murphy, whose testimony purported to focus on record company profitability, had her expert credentials revoked. RIAA RPFF Section VI.A. Dr. Landes has twice attempted to provide empirical analysis to this Court and each time it has been revealed both that his data set was skewed and that he flubbed his data analysis, generating results more favorable to the Copyright Owners than even the skewed data set warranted. RIAA RPFF Section VI.C.

95. In contrast, the Copyright Owners' criticisms of Dr. Wildman are *not* that he erred in any way, that he used the wrong or a skewed data set, or that he conducted his data analysis

inaccurately. Rather, the Copyright Owners' sole criticism is that he should have done more than he did and reviewed ever larger volumes of data over an ever longer period of time from more and more record companies. This criticism is unfounded.

96. Dr. Wildman examined data from the three largest record companies in the United States, representing almost 70% of the marketplace. Wildman WRT at 34-36, RIAA Trial Ex. 87. That data included data on every mechanical licensing transaction for specified time periods from each company. Although the data did not permit Dr. Wildman to combine the data sets, it did permit him to calculate multiple benchmarks on which this Court could rely as marketplace points of reference.

97. The Copyright Owners criticize Dr. Wildman for using data from a single calendar quarter from two different record companies such that it was not possible to do a time series analysis, CO PFF ¶ 702, but, as Dr. Wildman recognized, the best data would come from a time period when the statutory rate was the current rate (9.1 cents) and there was a sufficient period of time to allow all ownership disputes to be resolved and for some sales to occur. Wildman WRT at 35, RIAA Trial Ex. 87. Moreover, it is hardly fair to criticize Dr. Wildman for using two record companies when Dr. Landes's flawed songwriter analysis looked only at a single music publisher; indeed, Dr. Landes's empirical flaws are far worse because he represented that his study was of songwriter income—which cannot be fairly reflected by analyzing a single music publisher because many songwriters have multiple publishers (*see, e.g.*, John Lennon and Paul McCartney, both of whom appear in Dr. Landes's sample even though the Beatles catalog is owned by Sony/ATV, not UMPG, *see* RIAA PFF ¶ 537). In contrast, Dr. Wildman focused on all mechanical licensing transactions by the record companies at issue, not a subset of them.

98. The Copyright Owners claim that Dr. Wildman could not vouch for the representativeness of the data he analyzed, CO PFF ¶ 702, but Dr. Wildman made clear that he had a large volume of data that permitted him to reach clear conclusions and said only that he could not guarantee with absolute certainty that the precise average mechanical rates for different periods would be exactly the same. 5/12/08 Tr. 5922:8-17 (Wildman). He added that based on his knowledge of the marketplace, he would be very surprised if the data he analyzed was not fairly representative. 5/12/08 Tr. 5922:8-17 (Wildman). The Copyright Owners have done nothing to show that this expectation was incorrect.

99. Finally, the Copyright Owners criticize Dr. Wildman for presenting the mean and not the median, but he explained why he believed the mean to be a better measure of the actual rates that would be negotiated in the marketplace absent a compulsory license. CO PFF ¶ 703. He explained that the purpose of calculating a median as well as a mean is to study the variation in a data set, and that he had used a standard deviation for that purpose. 5/12/08 Tr. 5918:21-5919:8 (Wildman). Thus, the Copyright Owners do not actually find fault in his mean analysis—and indeed there is no basis for any criticism of that analysis.

100. The Copyright Owners also hint that the range of reasonableness revealed by Dr. Wildman's analysis is too broad because the average mechanical rate paid by different companies is different. As an initial matter, given that Dr. Landes's "range of reasonableness" is 30 percentage points, Copyright Owners have little cause to complain. In any event, Dr. Wildman indicated that the variation may well result from different mixes of music, 5/12/08 Tr. 5851:6-16; to the extent that a company sells a small number of units of different CDs, one would expect the average rate would be pulled up because transaction costs make it inefficient to negotiate reduced rate licenses for small sellers. A. Finkelstein WRT at 28, RIAA Trial Ex. 84.

101. In sum, the Copyright Owners' criticisms of Dr. Wildman do not undermine the reasonableness and credibility of his benchmarks in any meaningful way.

B. The 1981 CRT Decision and Historical Norms

102. RIAA also presented testimony from Dr. David Teece using the outcome of the 1981 Copyright Royalty Tribunal mechanical rate proceeding as a basis for recommending a new rate going forward. The results of Dr. Teece's analysis were fully consistent with Dr. Wildman's conclusions based on recent voluntary deals. The Copyright Owners mount three attacks on Dr. Teece's historical analysis, but none hits the mark.

103. First, the Copyright Owners say that the 1981 CRT proceeding is simply too distant in time to have relevance now. CO PFF ¶¶ 665-666. But the passage of time does not mean that this Court should not place some reliance on the determination made by the CRT about the value of musical compositions incorporated into sound recordings, relative to the wholesale price of those recordings. As noted at the outset, Dr. Landes's entire analysis relies on the assumption that there should be a constant relationship between the value of sound recordings and the value of mechanical rights (although he assumes incorrectly that the relationship should be the same for all products regardless of the differences in the products and consumer demand). If so, one would expect that ratio to be durable over time.

104. To be sure, as Dr. Teece testified, somewhere around the year 2000, the recording industry went through a "transformational change." 2/19/08 Tr. 3640:9 (Teece). But there is no reason to think that change affected the relative value of sound recordings and musical compositions on a CD. To the contrary, it was this transformational change, occasioned primarily by piracy, that altered the stable relationship between the price of recordings and mechanical royalty rates, creating the need for a reduction in mechanical rates to restore the

longstanding balance. The Copyright Owners have suggested no reason why the advent of illegal file sharing would suddenly mean that they deserve a greater share than previously of the revenues produced from legal sales of sound recordings.

105. In examining the relationship between mechanical royalties, wholesale prices, and retail prices, Dr. Teece is only following the instruction of the CRT, which reviewed such data going back in the 1960s and through a period of dramatic change (there growth) in the music industry. As the Librarian has indicated in the past, this Court must take as a given that the CRT's analysis in 1981 was correct, and prior copyright royalty tribunals have held that "trending forward" from an prior copyright royalty decision is a proper way to set rates—even 20 years into the future. *Noncommercial Educational Broadcasting Compulsory License,* 63 Fed. Reg. 49823, 49826 (Sept. 18, 1998) (using 1978 CRT decision as a benchmark and trending that rate forward to set rates for 1996 and beyond).

106. Second, the Copyright Owners dispute the specifics of Dr. Teece's calculation of a recommended rate of 7.8% of wholesale revenues, based on the 4-cent rate set in 1981 by the CRT. CO PFF ¶¶ 667-674. But this is much ado about nothing. The Copyright Owners do not dispute that Dr. Teece correctly calculated that the 4-cent rate was 5% of the list price of an album in 1981 ($7.98). The essence of their critique is that it was inappropriate for Dr. Teece to treat the list price in 1981 as the functional equivalent of actual average selling price, and to therefore apply that 5% figure to the actual average selling price in 2005 ($13.24) in order to come up with an appropriate percentage rate. CO PFF ¶ 670.[7] But that criticism is unsupported by the facts.

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[7] Dr. Teece multiplied the average selling price of CDs in 2005 ($13.24) times 5% to produce a royalty of $.662 per album. That figure, divided by the average wholesale price of an album in 2005 ($8.49), produces a percentage rate of 7.8%. Teece WDT at 81, RIAA Trial Ex. 64.

107. The Copyright Owners base their claim that there was a substantial amount of discounting off of list prices at the time of the CRT decision on evidence in the record of that proceeding showing that the average selling price of albums in 1979 was $5.79. CO PFF ¶ 672. But as Dr. Teece explained at trial, there is no basis for concluding, based on this evidence, that there was a substantial amount of discounting occurring at that time. To the contrary, the most likely reason for a substantial disparity between then-current list prices and average selling prices was that there was rapid inflation and inventory takes time to flow through the system. 2/19/08 Tr. 3782:15-19 (Teece). As he explained, inflation was running at double-digit rates during this period, 2/19/08 Tr. 3784:3-8 (Teece), and the nature of the distribution system was that "not everything that comes into a store gets sold the day it comes into the store. It sits on the shelf. And so you bring in stuff at list and when list is going up, you may find, in fact, that what people are paying going out the door doesn't necessarily reflect today's list, but an average of today's list plus yesterday's list." 2/19/08 Tr. 3784:18-3785:3 (Teece).

108. For his assumption that there was little discounting in 1981, Dr. Teece also relied on reports that discounting has drastically increased in more recent times with the advent of big-box retailers, combined with the fact that even today, the data show that the average difference between list prices and actual selling prices is only about 8-11%. 2/19/08 Tr. 3785:8-14 (Teece) (citing Teece WDT at App. D at Ex. D.4, RIAA Trial Ex. 64).

109. In any event, even if one entirely *eliminates* the assumption that list and actual selling prices were equivalent in 1981, the outcome is not materially different. The 4-cent rate in 1981 was 8.6% of wholesale revenues received by the record companies. 2/19/08 Tr. 3794:1-10 (Teece). That figure closely matches RIAA's current rate proposal of 9% of wholesale revenues.

110. Alternatively, one might multiply the 5% of retail list figure from 1981 times the average *list* price in 2005, which was $14.83. Teece WDT at App. D at Ex. D.4, RIAA Trial Ex. 64 (calculated by multiplying the average actual price reported by Dr. Teece times 1/.893). That would produce an average royalty of $.7415 per album, which when divided by the average wholesale price of $8.49 produces a percentage rate of 8.7%, which again is close to RIAA's current proposal.

111. Third, the Copyright Owners argue that Dr. Teece did not consider what royalty base would be multiplied by his recommended percentage rate. CO PFF ¶ 674. But that is simply untrue. An entire section of Dr. Teece's written direct testimony asserts that the royalty base should be actual wholesale revenues of record companies derived from the sale of sound recordings. Teece WDT at 74-75, RIAA Trial Ex. 64. That section of the testimony even notes that in many situations, the revenue base for royalties is defined as excluding returns and perhaps other costs like shipping. Teece WDT at 75, RIAA Trial Ex. 64.

112. The assertion that Dr. Teece did not consider the royalty base is premised on a passage in Dr. Teece's cross-examination where he stated that the law would define the revenue base. CO PFF ¶ 674 (citing 2/19/08 Tr. 3698-3701 (Teece)). In this passage, Dr. Teece was clearly assuming that the question related to which *products* are within the scope of the mechanical compulsory license. 2/19/08 Tr. 3700:3-5 (Teece) ("I'm not a lawyer. But I know there is, for instance, maybe some issue around ring tones."). He added that "[o]nce the law is clear, I think it's relatively straightforward to figure out what products need to be counted." 2/19/08 Tr. 3699:20-3700:1 (Teece).

113. It is with this in mind that one must read Dr. Teece's statement that "I haven't set the base." 2/19/08 Tr. 3701:1 (Teece). In context, it is clear that he was saying that it was not up

to him to decide which products are subject to mechanical royalties. He was not disclaiming the section in his written direct testimony discussing the revenue base to which the 7.8% rate would apply. Thus, the Copyright Owners' claim is nothing more than a mischaracterization of Dr. Teece's testimony.

C. Mechanical Royalty Rates in Comparable Foreign Markets

114. RIAA established at trial that mechanical royalty rates in the two most comparable markets, the U.K. and Japan, are lower for both physical products and downloads. RIAA PFF Section III.F. Nothing in the Copyright Owners' Proposed Findings of Fact disputes that claim or establishes that those markets are inappropriate comparators.

1. The Copyright Owners Fail to Offer Any Sound Basis for Rejecting RIAA's Comparison to the Royalty Rates in the U.K. and Japan.

115. The Copyright Owners' findings of fact concerning international rates are long on conclusory allegations, but short on relevant facts and sound reasoning. CO PFF Section XV.B.4. The Copyright Owners never once in their findings of fact offer any sound basis not to use the U.K. and Japanese rates as a benchmark for setting the statutory rate in this proceeding. Indeed, in simply asserting that those rates are not an appropriate benchmark, the Copyright Owners completely ignore the CRT's conclusion that "the foreign experience is relevant" to setting U.S. rates and is in fact "a benchmark" for assessing whether copyright owners receive a fair return. *1981 Mechanical Royalty Proceeding*, 46 Fed. Reg. at 10483-84. *See* RIAA COL Section II.E. Nor do the Copyright Owners try to reconcile their position with the D.C. Circuit's conclusion that the Court is not required to "close its eyes to conditions in other countries while deciding what a fair return to a composer should be." *Recording Industry Ass'n of America v. CRT*, 662 F.2d 1, 10 n.23 (D.C. Cir. 1981). *See* RIAA PFF ¶ 698.

116. The Copyright Owners' first criticism of RIAA's international comparisons is disingenuous, at best. The Copyright Owners mischaracterize the testimony of RIAA expert witness Steven Wildman concerning international rates, claiming that Professor Wildman disagreed with the U.K. and Japanese rate benchmarks because he "refused to endorse" and "he cannot support them." CO PFF ¶¶ 710, 725. This claim distorts the record. Professor Wildman was asked if he had performed any analysis or study on the U.K. or Japanese markets. His answer—*six* separate times—was that he had not conducted such an analysis or study. 5/12/08 Tr. 5987:2-5988:18 (Wildman). Not once did Professor Wildman find any fault or point out any problem with using international rates. Not once did he reject international rates as a benchmark or suggest that had he studied those rates and markets, he would have concluded them to be an inappropriate benchmark. Not once did he find any fault with the testimony of either Geoffrey Taylor or Richard Boulton. Professor Wildman did not study the international rates in the U.K. and Japan and thus cannot "endorse" their use as benchmarks, much as Professor Murphy presumably cannot endorse Judith Finell's testimony about musicology.

117. The Copyright Owners next point to differences among the U.S., U.K. and Japanese markets. *See* RIAA COL Section II.E. But they fail to explain why these differences should disqualify the U.K. and Japanese rates as benchmarks. Nor do the Copyright Owners dispute the many important ways in which the music industry in the U.S. is similar to the music industries in both the U.K. and Japan. The closest the Copyright Owners come to addressing the similarities among the music markets in the U.S., U.K. and Japan is in one brief paragraph at the end of their discussion of international rates. CO PFF ¶ 721.

118. First, the Copyright Owners note that the U.S. market is larger than the U.K. market. CO PFF ¶ 721. But they miss the salient point—the U.K.'s market's size relative to

other national markets that might be compared to the U.S. They cannot dispute that relative to the world, the U.S. and the U.K. markets, along with the Japanese market, are the three largest and most developed and therefore the most comparable to one another. RIAA PFF ¶¶ 706-08. To the extent relative size matters, that only demonstrates the need to look to the U.K. first as a comparable benchmark before looking at nations with an even greater relative size disparity.

119. Second, the Copyright Owners trumpet that the Japanese do not export as much music as the other two nations. CO PFF ¶ 721. They do not, however, explain why this alleged difference, by itself, makes Japan an inappropriate comparator.

120. Third, the Copyright Owners suggest the U.K. and Japan are poor benchmarks because there is no compulsory license in the U.K. and it has not been necessary to arbitrate mechanical royalty rates in Japan. CO PFF ¶ 712. It is unclear why the Copyright Owners think this renders those countries inappropriate benchmarks. There is a Copyright Tribunal in the U.K. established by statute that sets mechanical royalty rates that must be used in the absence of industry agreements; that Tribunal is the U.K. equivalent to this Court, although the parties have reached voluntary settlement. RIAA PFF ¶ 714.

121. Fourth, the Copyright Owners point to the existence of controlled composition clauses in the U.S. as a difference between the U.S. and the U.K. CO PFF ¶ 713. But while this may affect an international comparison of effective rates, the comparison drawn here by RIAA is between the mandatory rates set in the U.K. and the *statutory* rates that this Court is empowered to establish. The fact that the rates this Court sets may be more readily discounted pursuant to voluntary agreements to accept controlled composition clauses is irrelevant to that comparison. Moreover, as the Copyright Owners' own witness Jeremy Fabinyi readily acknowledged at trial, for DPDs, the U.S. statutory rate trumps the rates set by controlled composition clauses in post-

1995 artist contracts, and therefore cannot be distinguished from U.K. rates on this basis. 5/15/08 Tr. 6857:3-22 (Fabinyi).

122. While the Copyright Owners claim that the prevalence of controlled composition clauses is also a distinction between the U.S. and Japan, *see* CO PFF ¶ 713, they cite no evidence in the record whatsoever concerning controlled composition clauses in Japan.

123. The final purported difference asserted by the Copyright Owners is that Published Price to Dealer or "PPD" in the U.K. is different than the actual wholesale price received by record companies in the U.S. CO PFF ¶¶ 716-718. To support this claim, the Copyright Owners rely heavily on Jeremy Fabinyi's unsupported and misleading testimony that discounting off of the PPD rate in the U.K. can be as high as 40%. But the record shows that Mr. Fabinyi acknowledged at trial that the average discount in the U.K. is in fact closer to half of his reported figure. RIAA PFF ¶ 725. This concern is thus substantially overblown. Indeed, even if the Court were to accept Mr. Fabinyi's testimony on this point, it would result in a U.K. rate equivalent to 11.1% of wholesale, or approximately 8.0 cents—far below the current statutory rate and significantly less than the rates the Copyright Owners proposed. *See* RIAA RPFF Section I.

124. Moreover, the Copyright Owners assert this difference between the calculation of PPD and wholesale price as if it would categorically distinguish rates in the U.K. from rates in the U.S., but the purported distinction has no relevance at all in the context of permanent downloads. The U.K. royalty rate for permanent downloads is based on the retail price (less VAT) paid in the U.K., not on PPD. RIAA PFF Section III.F.3.d. Thus Mr. Fabinyi's critique has no applicability at all.

125. In contrast to the Copyright Owners' half-baked efforts to distinguish the U.K. and Japan, RIAA has presented robust and thorough testimony that demonstrates the similarities among the comparable markets while acknowledging the less-significant differences. *First*, these are the three most developed music markets in the world, with the highest total retail revenue from music, highest recorded music sales value, percentage of total sales, digital music sales, and singles sales. RIAA PFF ¶¶ 706-707. *Second*, these are the three countries that are world leaders in developing the online marketplace. RIAA PFF ¶ 708. Indeed, as between the U.K. and the U.S., there are even greater industry similarities, including heavy expenditures in A&R, investment in fighting piracy, an international focus on exporting music. RIAA PFF ¶¶ 709-711. *Third*, the music industries in all three of these nations have experienced similar damaging changes in which the growth of online sales has not been sufficient to compensate for the decline in sales of physical products. RIAA PFF ¶¶ 712-713. *Fourth*, in all three nations there is a mechanism in place to set reasonable royalty rates if and when the parties cannot agree. RIAA PFF ¶ 714. Taken together, the U.S, U.K. and Japan are similar in their place atop the global market, their pioneering position in the online marketplace, their recent industry experience with declining physical sales, and their legal provision to ensure the opportunity for access to musical works even if the parties disagree. These similarities establish that the marketplace conditions in the U.K. and Japan for setting mechanical royalty rates are the *most* comparable to those in this country.

126. RIAA also provided uncontested evidence that the differences between the U.S., on the one hand, and the U.K. and Japan, on the other, would support the conclusion that the rate in the U.S. should be *lower* than the rates in the U.K. or Japan. RIAA PFF Section III.F.4. This is consistent with the conclusion of the CRT in 1981, which found that the sheer size of the U.S.

market supported a lower rate than abroad. *1981 Mechanical Royalty Proceeding*, 46 Fed. Reg. at 10484.

127. RIAA has also submitted evidence establishing the proper method for translating the U.K. online rate into a U.S. percentage of wholesale rate. The detailed expert testimony of Richard Boulton provided a step-by-step analysis of how this Court could take the U.K. royalty rate for permanent downloads and come up with an equivalent mechanical royalty rate for this country. RIAA PFF ¶¶ 735-743. His analysis shows that U.K. mechanical rate for downloads translates to 7.7% of wholesale. RIAA PFF ¶ 741. As the Chief Judge noted, Mr. Boulton's testimony was "a refreshing reminder of the appropriate role of an expert." 2/13/08 Tr. 3000:8-9 (Boulton).

128. The Copyright Owners do not dispute the merits of Mr. Boulton's testimony. Instead, they attack Mr. Boulton's testimony by claiming that his prior testimony in a U.K. rate proceeding more than 10 years ago (before there was any noticeable online market) was inconsistent with his testimony in this Court. CO PFF ¶ 720 (noting prior testimony that international rates are of "limited usefulness" and any international differences must be taken into account). The Copyright Owners' attacks on Mr. Boulton are achieved only by distorting the evidence. Mr. Boulton stated that the quotation cherry-picked by the Copyright Owners' counsel that is now the basis of the attack in their findings of fact was "specific to the circumstances of a U.K. satellite broadcaster." 2/13/08 Tr. 2978:8-10 (Boulton).

129. In addition, as Mr. Boulton explained, in his more recent testimony before the 2006 U.K. tribunal concerning the use of the 1997 United States rate as a benchmark *for other nations*, his testimony was influenced by the fact that he was aware that this Court would be setting a U.S. mechanical rate in this proceeding and he was concerned about "a sort of cart

before the horse issue" since he would have wanted to know what this Court decides before assuming the U.S. mechanical rate. 2/13/08 Tr. 2945:7-2946:10 (Boulton).

130. Perhaps most importantly, Mr. Boulton made clear that, in those prior circumstances, international rates were relevant in principle but his concern was how they were applied in practice. 2/13/08 Tr. 2944:17-2945:20 (Boulton). Mr. Boulton testified that prior U.K. tribunals "have 50 different rates thrown at them, and each party has advanced 25 of those rates as being helpful to their cases . . . [and] this isn't really helpful" to the tribunals. 2/13/08 Tr. 2944:17-2945:6 (Boulton). This, of course, is a sharp contrast to the focused and detailed testimony put forward by RIAA through Geoffrey Taylor identifying two specific nations—the U.K. and Japan—and explaining why they are the best comparators for the Court in this proceeding. It is therefore not surprising that as an expert witness Mr. Boulton opined that at this time, the U.K. rate for permanent downloads was a "relevant benchmark" that would be helpful to look to. 2/13/08 2946:11-2947:18 (Boulton).

2. The Copyright Owners' Comparisons to Rates in Other Countries Are Useless.

131. The Copyright Owners claim that "the current U.S. statutory rate for physical product is well in line with mechanical rates around the world when those rates are compared on a currency adjusted basis." CO PFF ¶ 722. This claim does not withstand scrutiny. The sole basis for the Copyright Owners' claim is the testimony of Jeremy Fabinyi. RIAA thoroughly discredited Mr. Fabinyi's methodology (or lack thereof) in its Proposed Findings of Fact, and for all of the reasons set forth there, Mr. Fabinyi's comparisons to rates in other countries should be rejected by this Court. *See* RIAA PFF Section III.F.5. Indeed, even though RIAA challenged Mr. Fabinyi's methodology during trial, the Copyright Owners' findings of fact do not include a

single sentence to explain the manner or method in which he performed his so-called "analysis." *See* CO PFF ¶¶ 722-723.

132. The Copyright Owners' claim that the U.S. rate is in line with rates in other countries is noteworthy for two other reasons. First, it is surprising, to say the least, that the Copyright Owners now seek to rely on Mr. Fabinyi's calculations to compare the U.S. rate with rates in other countries given that Mr. Fabinyi himself emphasized that the rates he calculated are not "comparables in any . . . way" and should not be used to set the rate in the U.S. RIAA PFF ¶¶ 749-51.

133. Second, the Copyright Owners have phrased their comparison in terms of the rates for "physical product" only, and thus appear to have abandoned any suggestion that rate for downloads in the U.S. is in line with other countries. CO PFF ¶ 722. That concession is compelled by the evidence—the record makes clear that the U.S. mechanical rate for downloads is extremely high compared to rates in other countries, and is higher than in every country except Germany when expressed as a percentage of retail price. RIAA PFF ¶ 763. Indeed, Mr. Fabinyi testified that he was not aware of any country in the world that pays a mechanical rate for downloads as high as the rate proposed by the Copyright Owners in this proceeding. RIAA PFF ¶ 700.

134. The Copyright Owners largely ignore the reasons why nations besides the U.K. and Japan do not serve as good comparators to the U.S. for purposes of setting the mechanical rate. *See* RIAA PFF Section III.F.5.b. The only attempt by the Copyright Owners to salvage their European comparison is to assert that there is regulatory oversight over mechanical royalty rates in those nations. CO PFF ¶ 724. They do so by citing to the assertion by Mr. Fabinyi that such oversight exists in almost every—if not every—European country. But, Mr. Fabinyi could

not provide support for this assertion when questioned on cross-examination and conceded that some European countries have no such oversight. RIAA PFF ¶ 770. That is certainly not a sufficient basis for using European nations instead of the U.K. and Japan as comparators.

135. Finally, the one mechanical royalty rate for physical products that Mr. Fabinyi described as being "of particular note"—the Canadian rate for physical products which was produced by a recent settlement—is *lower* than the current U.S. rate, even when converted into U.S. dollars using Mr. Fabinyi's methods. According to Mr. Fabinyi's calculations the Canadian rate for physical products is 7.9 cents per track in U.S. dollars, and the Canadian rate for downloads is 8.51 cents per download in U.S. dollars. *See* CO PFF ¶¶ 722-723 (citing Fabinyi exhibits F-1 and F-2). And this rate is inflated because it is based on a rate of 8.8% of retail, but, in fact, the relevant decision of the Copyright Board of Canada conferred a 10% discount from that rate. Fabinyi WRT at Ex. E at 53, CO Trial Ex. 380. The effective rate issued was thus 7.9% of retail.

D. A Rate Cut Is Also Justified by Dr. Murphy's Economic Theory

136. The Copyright Owners cite Professor Murphy for the proposition that "demand reduction in an environment of falling prices will require a relative increase in songwriter compensation to maintain the supply of songs." CO PFF at ¶ 74. The quoted statement is flatly untrue. Professor Murphy said no such thing. In fact, what Professor Murphy said was that falling demand for the final product—sound recordings—will reduce the demand and *the compensation paid* for musical works or songs. 5/15/08 Tr. 6922:12-17 (K. Murphy) (Q: "And if the demand for songs, as an input to the sound recordings, falls, we can expect the market price for songs to fall, correct?" A: "The market price, yes, per song delivered, yes."). He explicitly agreed that, in fact, demand for sound recordings has fallen, 5/15/08 Tr. 6873:7-11, 6922:18-

6923:1 (K. Murphy), and compensation for songs must fall as well. 5/15/08 Tr. 6927:10-18 (K. Murphy).

137. Professor Murphy's principal claim was that, although compensation for songs must fall in response to falling demand, the compensation has already been reduced because, in the current market environment, fewer copies of each song are being sold. If the compensation for each song written has dropped because fewer copies of each song are being sold, he opined, it may not be necessary to further reduce compensation by also cutting the royalty paid for each copy. 5/15/08 Tr. 6945:5-6946:5 (K. Murphy).

138. Professor Murphy's theoretical analysis thus does not answer the question of whether the mechanical rate should go up, down, or stay the same. He agrees that demand for sound recordings and songs has declined. 5/15/08 Tr. 6873:7-11, 6922:18-6923:1 (K. Murphy). He agrees that the compensation for songs, and therefore the supply of songs, should also decline. 5/15/08 Tr. 6922:12-17 (K. Murphy). He states that compensation has already declined to some degree because fewer copies are songs are being sold. 5/15/08 Tr. 6945:5-6946:5 (K. Murphy). But whether a change in the royalty rate per copy—either up or down—is necessary in order to maintain the appropriate supply of songs given the reduced demand is a question that his theory (even if it was correct) does not answer. 5/15/08 Tr. 6946:15-6947:17 (K. Murphy).

139. Professor Murphy, however, offers little more than theory. He does not know what the elasticity of supply for songs is, or how the supply of songs relates to the mechanical rate. 5/15/08 Tr. 6947:10-21 (K. Murphy). Moreover, he acknowledges that many factors affect whether a song is written, in addition to the mechanical royalty rate. Among other things, songwriter compensation depends on the number of units sold, which in turn depends on which artist performs the song, who produces the song and how it is produced, the marketing resources

devoted to selling the sound recording, and other factors that no one can predict. 5/19/08 Tr. 6977:19-6979:17 (K. Murphy). For singer/songwriters, an incentive to write songs exists in order to advance the writer's career as a singer, and therefore the mechanical royalty becomes less relevant. 5/15/08 Tr. 6950:16-6952:16 (K. Murphy). And songwriters have opportunities to earn other types of royalties, such as performance royalties and synch rights. 5/15/08 Tr. 6959:20-6960:3 (K. Murphy). Consequently, much of Professor Murphy's testimony is a purely theoretical discourse on one component of the incentives that affect the supply of songs, and simply does not help the Court determine whether and how to change the mechanical royalty rate.

140. The only empirical evidence that Professor Murphy reviewed in an effort to assess whether the mechanical rate should change from current levels was the compensation paid by record companies to other creative inputs—chiefly artist royalties and advances and recording expenses. K. Murphy WRT at 9, CO Trial Ex. 400 (definition the "creation step" as including "the mechanical royalties, artist royalties, and advances and recording expenditures to acquire songs and artist talent needed to make a master recording"). He believes that mechanical royalties should "evolve in much the same way" that artist royalties and advances and recording expenditures do. Murphy WRT at 8-9, CO Trial Ex. 400; 5/15/08 Tr. 6887:15-6890:2 (K. Murphy). Based on his analysis of artist royalties and advances and recording expenses, Professor Murphy opined that the mechanical rate should not go down. By the same token, however, he did not support the Copyright Owners' request for an increase in the rate. In response to questions from Judge Wisniewski, Professor Murphy conceded that his analysis suggests that the current rate should remain in place. 5/19/08 Tr. 7022:1-7023:4, 7023:21-7024:6 (K. Murphy); *see also* 5/15/08 Tr. 6899:2-12 (K. Murphy).

141. Moreover, it is important to recognize that Professor Murphy's empirical analysis was conducted in a way calculated to mask the relative changes in mechanical royalties compared to artist royalties and advances and recording expenses (which are one of the principal components of A&R). For example, he omits from his Figure 2 a line for advances and recording expenses—although he has a line for mechanical royalties and a line for artist royalties—because advances and recording expenses experienced a negative compound annual growth rate of 7.1% between 1999 and 2006, while mechanical royalties had a positive growth rate during the same period. Benson WRT at 8, RIAA Trial Ex. 82. Moreover, by calculating the comparison between payments for mechanical royalties and payments for other creative inputs as a percentage of total revenue, Professor Murphy minimized the differences in growth rates. An example will make the point. Suppose mechanical royalties are 5, artist royalties are 20, and total costs are 100. If both mechanical royalties and artist royalties increase by 5, Professor Murphy's table would show that both mechanical royalties and artist royalties increased by 5% of total cost. Thus, Professor Murphy would claim that mechanical royalties and artist royalties moved in perfect synch with one another. Yet in this hypothetical, mechanical royalties rose by 100%, from 5 to 10, while artist royalties increased by only 25%, from 20 to 25. From the perspective of incentives to increase the supply of songs (which is the issue that purports to concern Professor Murphy), a 100% increase in compensation surely has far more impact than a 25% increase, and yet Professor Murphy's method of displaying the data makes the two look equal.

142. Even if one accepts Professor Murphy's opinion that mechanical royalties should track the compensation paid for other creative inputs, however, a closer look at the evidence compels the conclusion that the current mechanical rate is too high. At the most basic level,

between 1999 and 2006, mechanical royalties paid by the major record companies rose from $512 million to $547 million, while artist royalties declined from $1,228 million to $1,104 million, and advances and recording expenditures declined from $412 million to $246 million. Benson WRT at 8, RIAA Trial Ex. 82. In short, if Professor Murphy is correct that mechanical royalties should move in the same direction as other creative inputs, the record is clear that for the major record companies, mechanical payments are rising while expenditures for artist royalties and advances and recording are falling—precisely contrary to what Professor Murphy says should happen.

143. The conclusion that mechanical rates are too high, applying Professor Murphy's theory, becomes even clearer when one looks at per unit payments. Professor Murphy suggested that it was appropriate to compare mechanical rates with the cost of all creative inputs, which he defined to include artist royalties and advances and recording expenses. Murphy WRT at 9, CO Trial Ex. 400. The combination of artist royalty and advances and recording expenses equaled 19.9 cents per unit sold in 1999 and, after a modest rise in the intervening years, it returned to precisely the same level of 19.9 cents per unit sold in 2006. Benson WRT at 15 (Figure 4a, adding artist royalty and advances and recording expenses), RIAA Trial Ex. 82. If Professor Murphy is correct, therefore, the statutory mechanical royalty rate in 2006 should have returned to its 1999 level of 7.1 cents instead of increasing to the current 9.1 cents.

144. Even if one looks only at artist royalties (as Dr. Murphy concedes is incorrect), the conclusion remains that the current mechanical rate is too high. In 1999, artist royalties averaged 14.9 cents per unit, and in 2006 artist royalties had risen approximately 9% to 16.3 cents per unit. Benson WRT at 15, RIAA Trial Ex. 82. Had the statutory rate also increased by

9% during that same time period, it would have risen from the 1999 rate of 7.1 cents to only 7.8 cents.

145. Lest the record companies be accused of cherry-picking the data, the same conclusions result no matter what year you look at. Thus, if one compares the artist royalty rate of 14.9 cents per unit in 1999 to the artist royalty rate per unit in 2002 of 17.8 cents per unit—the highest rate in the entire eight-year period—the increase in artist royalties per unit is only 16.3%. Benson WRT at 15, RIAA Trial Ex. 82. If the statutory mechanical rate rose by 16.3% from its 1999 level of 7.1 cents, it would equal only 8.5 cents today.

146. The conclusion of this analysis is clear. Artists, like songwriters, have suffered from declining unit sales. Just like the songwriters, their compensation per sound recording has decreased because, on average, fewer copies of each sound recording are being sold. But while the songwriter royalty per copy sold has increased by 22% (from 7.1 cents to 9.1 cents) between 1999 and today, the compensation for other creative inputs on a per unit basis has increased not at all (if one looks at the combination of artist royalties and advances and recording costs), or has increased by only 9% (if one looks only at artist royalties). Benson WRT at 15, RIAA Trial Ex. 82. If the Court accepts Professor Murphy's thesis, therefore, it should reduce the mechanical rate.

E. Ringtones Are a Distinct Market Requiring Separate Treatment

147. As explained in RIAA PFF IV.D.2, ringtones inhabit a different market from CDs and digital downloads, and therefore require a different analysis in setting rates.

148. In the webcasting case, this Court found that simulcasters and Internet-only webcasters are substitutional for each other and inhabit the same market; as a consequence, economic theory compels that they pay the same rate. *Webcasting II Decision,* 72 Fed. Reg. at

24095. By contrast, the Court found that small non-commercial webcasting services do not substitute for and do not inhabit the same market as commercial webcasters, requiring different treatment. *Webcasting II Decision,* 72 Fed. Reg. at 24097-99. In other words, whereas rates for Internet-only webcasters could serve as a benchmark for simulcasters, they cannot serve as a benchmark for non-commercial webcasters.

149. In this proceeding, there can be no dispute that CDs and digital downloads substitute for each other and inhabit the same market, requiring similar treatment with respect to the manner in which rates are set. At the same time, as Dr. Wildman and Dr. Slottje both explain, RIAA PFF Section IV.D, ringtones do not substitute for CDs and digital downloads and do not fulfill the same consumer need; as such, they inhabit a separate consumer market and require different treatment. In other words, one cannot use ringtones as a benchmark for setting rates for CDs and digital downloads by simply translating rates from one to the other, as Dr. Landes has attempted to do.

150. In setting rates for mastertones, Dr. Wildman has provided the Court with a range of possible rates for ringtones using a surplus analysis. This methodology—which corrects the flaws in Dr. Landes's analysis—is a far better means of setting rates for ringtones than the Copyright Owners' approach, which takes the already inflated NDMA rates and then increases them (for no known reason) beyond a reasonable level. RIAA PFF Section IV.D.8.b.

151. Alternatively, in the event that the Court finds the NDMAs a persuasive benchmark for ringtones and the Court prefers a cents rate, the NDMAs provide cents rates that cluster between 10 and 12 cents per ringtone. RIAA PFF Section IV.E. Moreover, in that event, the record compels the conclusion that (a) the rates for CDs and digital downloads must be set on the basis of the benchmarks presented by RIAA and (b) other provisions of the NDMA

agreements implicated here, such as the manner in which royalties are calculated for multi-session products and locked content, must also be given force and effect, as they are in RIAA's Second Amended Rate Proposal.

III. THE COPYRIGHT OWNERS' BENCHMARKS ARE FLAWED.

152. The Copyright Owners have presented this Court with a purported "range of reasonableness" that spans 30 percentage points, up to half of all wholesale revenues in the music industry, and have argued that anything below 30% of record company revenues is the low end of a range. *See, e.g.*, CO PFF ¶¶ 543-545. The rates they have proposed based on this range would reflect a dramatic increase in the royalty rates paid for mechanical licenses for CDs and digital downloads that is out of line with all historical norms and the marketplace transactions that the Copyright Owners enter into every day. RIAA PFF Section III.C-D.

153. As discussed in more detail in Section II.E of RIAA's Proposed Findings of Fact, there is no justification in the marketplace for such a radical increase. Wholesale and retail prices of sound recordings have dropped, as have units sold and wholesale revenues. The statutory rate is currently equivalent to a higher percentage of the wholesale and retail price of sound recordings than ever before due to the decline in record prices combined with the effect of the 1997 agreement on mechanical rates, which wrongly presumed that record prices would continue to increase in the coming years. RIAA PFF Section III.D.

154. The sole basis for the Copyright Owners' request for a massive increase in the mechanical rate is Dr. Landes's benchmark analysis. Recall that the Copyright Owners' other expert witness, Dr. Murphy, testified that his analysis did *not* support a rate increase. 5/19/08 Tr. 7023:4-7024:6 (K. Murphy). The very fact that the Copyright Owners' benchmark analysis suggests a massive increase itself should raise eyebrows. If every other market indicator

demonstrates that rates should go down, one should ask serious questions about an analysis premised on the idea that a massive increase is compelled. Indeed, as discussed below, everything about the Copyright Owners' benchmark analysis is fatally flawed, including their refusal even to consider whether the benchmarks that they advance are comparable, and their state of denial about the markets for CDs and digital downloads.

A. Dr. Landes's Approach to Selecting and Analyzing Benchmarks Is Fatally Flawed.

1. Dr. Landes Failed to Analyze the Comparability of His Benchmarks.

155. As discussed in Section III.A.2 of RIAA's Proposed Findings of Fact and Section II.B.2 of RIAA's Proposed Conclusions of Law, this Court has made clear that, with respect to an analysis of appropriate benchmarks, the comparability of the benchmark market to the target market is central to whether a benchmark provides any useful information about the rates at issue under a statutory license. In particular, the Court's decisions have made clear that simply because a copyrighted work is an input to two different products does not mean that the rates paid for one are useful in setting the rates paid for another. *SDARS Decision*, 73 Fed. Reg. at 4089. In assessing comparability, it is critical to look at the ultimate consumer product because it is from that product that the value of the copyrighted work is derived. *PES I Librarian's Decision*, 63 Fed. Reg. at 25397.

156. The Copyright Owners give lip service to the notion that comparability is of critical importance, but then provide no evidence of comparability to support their benchmarks. That makes it all the more stunning that neither they nor their economists even try to examine the comparability of their proposed benchmarks to the markets for CDs and digital downloads that make up the vast majority of products that will be affected by this proceeding.

157. Section XII.B of the Copyright Owners' Proposed Findings of Fact is instructive. In this section, the Copyright Owners purport to explain the "rigorous" criteria that Dr. Landes used in selecting benchmarks. Even a cursory review of that section demonstrates that Dr. Landes utterly failed to examine whether the benchmarks he was offering are comparable to the market for CDs and digital downloads, for which he is recommending a drastic rate increase of between 37% (for CDs) and 65% (for digital downloads). As Dr. Wildman explained, it is this total failure to address comparability that led Dr. Landes to propose a range of reasonableness spanning 30 percentage points—one that would result in, for example, a range of "reasonable" digital download rates from 14 cents to 35 cents. Wildman WRT at 9-10 & n.5, RIAA Trial Ex. 87.

158. In Section XII.B of the Copyright Owners' Proposed Findings of Fact, the Copyright Owners cobble together parts of Dr. Landes's testimony (because he nowhere explains how one should view the question of comparability) to identify four criteria for use in selecting benchmarks. Those are: the benchmark must (a) "arise from voluntary market transactions" (CO PFF ¶ 486); (b) "be unaffected by a statutory license, such as Section 115, or any other price control" (CO PFF ¶ 487); (c) "provide[] information regarding the *relative* valuation of the musical composition and sound recording" when the musical work is embedded in a sound recording (CO PFF ¶ 488); and (d) "require users to acquire separate licenses for both the copyrighted musical composition and the sound recording" (CO PFF ¶ 489). These are all simply different ways of saying that in selecting benchmarks, Dr. Landes did *nothing* more than determine that the markets to which he looked involved both musical works and sound recordings.

159. As is obvious from the listed criteria, Dr. Landes's criteria have nothing to do with comparability, as this Court has explained it. Dr. Landes has never explained why he chose the ringtone market and the synch market but not webcasting (statutory or not) or music videos (each of which also involves musical works and sound recordings), and he never looked at all at the ultimate consumer products at issue. Were Dr. Landes's non-analysis the appropriate means to examine comparability, then this Court's decision in the SDARS case would make absolutely no sense at all. *SDARS Decision*, 73 Fed. Reg. at 4089.

160. As this Court found in analyzing comparability in the SDARS proceeding, one must consider the underlying products sold to consumers and the characteristics of those markets. *SDARS Decision*, 73 Fed. Reg. at 4089. Under Dr. Landes's simplistic analysis, the PES statutory rate would have been a good benchmark for the SDARS statutory license, which of course it was not. The PES services provided a poor benchmark for the SDARS service because consumers viewed the services completely differently and purchased them for completely different purposes. *SDARS Decision*, 73 Fed. Reg. at 4089. It is this fundamental inquiry that Dr. Landes completely failed to undertake.

2. Dr. Landes Does Not Even Apply His Own "Criteria" Consistently.

161. Even if the Court was to conclude that Dr. Landes's criteria bear any resemblance to the analysis of comparability that this Court has said economists must undertake, it should reject Dr. Landes's discussion of benchmarks because Dr. Landes himself did not apply the criteria consistently.

162. First, Dr. Landes can provide no explanation as to why he chose the benchmarks that he did, yet ignored all other markets in which sound recordings and musical works are licensed or sold and which appear to meet his criteria at least as well as the three benchmarks he

advanced. Thus, Dr. Landes does not explain why he ignored webcasting, satellite radio, music videos, background music services, etc. It is not even clear whether he considered any other markets, apart from the three that appear to provide the most favorable rates to Copyright Owners for use in this proceeding.

163. Second, even the three benchmarks that Dr. Landes put forth do not actually meet his own criteria. The AHRA, for example, is not a free market transaction, involves a price mandated by law, and does not involve licensing of any kind. The market for synchronization rights involves completely separate licensing for the rights at issue, and the musical work at issue in synchronization licensing is not, at least from a licensing perspective, embedded in the sound recording. Finally, ringtones are covered by the statutory license. Thus, Dr. Landes has failed to apply his criteria for benchmarks faithfully.

164. Third, Dr. Landes's apparent justification for claiming that the ratio of the mechanical royalty rate to the wholesale price of sound recordings should be the same in all markets appears inconsistent with the three markets that he has chosen. In his testimony, Dr. Landes explained that the rationale behind his "common framework" for setting rates and terms across all products, *i.e.*, for assuming that the ratio of the mechanical royalty to the wholesale price of a sound recording should be similar across different products, is that "[t]he new business models for delivery of recorded music are substitutable for one another." Landes WDT at 7, CO Trial Ex. 11.

165. But the record demonstrates that none of the benchmarks that he chose are in any way substitutable for CDs or digital downloads. In particular, hearing a sound recording in the background of a movie or a television commercial does not substitute for purchasing music to listen to. Similarly, a ringtone does not substitute for sales of CDs or digital downloads, but

rather substitutes for a ringer on a cellular phone. Slottje WRT at 19-20, RIAA Trial Ex. 81. Thus, the apparent rationale for Dr. Landes's entire approach to transposing rates from one market to another is wholly eroded.

3. Dr. Landes's Approach—a Blanket Assumption That the Ratio of the Royalty for Musical Works to the Royalty for Sound Recordings Must Always Be the Same—Is Inconsistent with the Testimony of Dr. Murphy, the Copyright Owners' Own Rate Proposal, and the Evidence They Have Presented.

166. Dr. Landes's analysis is premised on the idea that the relative value of musical works and sound recordings should be the same in the market for CDs and digital downloads as it is in other markets. But the vast range between his 20% lower bound (mastertones) and his 50% upper bound (synchronization) demonstrates that Dr. Landes's premise of consistent relative valuation for widely different uses is not true. Indeed, at the same time as Dr. Landes argues that the division of the surplus should be the same across all markets as a theoretical matter, the Copyright Owners propose rates that vary significantly in terms of the manner in which they divide the content pool. In the end, Dr. Landes has no answer for why the ratio between what record companies are paid and what music publishers are paid is 4:1 in the mastertone market and 1:1 in the synchronization market, and why it should not be 10:1 in the market for CDs and digital downloads.

167. Indeed, Dr. Murphy, the Copyright Owners' rebuttal economist, argued precisely the opposite of what Dr. Landes hypothesized. Dr. Murphy testified that one should not expect a constant relationship between what record companies are paid for recordings and the mechanical royalty rate. CO PFF ¶ 729 ("'A benchmark based on a fixed ratio between the price paid to an input (songwriters) and the price of the output (recorded music) . . . is not an appropriate indicator of market values'" under conditions of falling sales and prices of CDs) (quoting K.

Murphy WRT at 6, CO Trial Ex. 40). In Dr. Murphy's view, the basic premise of Dr. Landes's argument is simply wrong when applied across all products for all times.

B. Ringtones

168. As discussed in Section IV.D of RIAA's Proposed Findings of Fact, the mastertone benchmark on which Dr. Landes and the Copyright Owners place so much reliance is fundamentally flawed for a multitude of reasons. Because they cannot rebut these critiques, the Copyright Owners resort to sleight of hand.

169. They say, for example, that Dr. Wildman "conceded he has no expertise" in the bargaining theory he discussed in his testimony. CO PFF ¶ 45 (citing 5/12/08 Tr. 5935-47 (Wildman)). But nowhere in the twelve pages of testimony cited did Dr. Wildman remotely make such a concession. To the contrary, the evidence shows that Dr. Wildman has more than sufficient expertise in this area. He explained that bargaining theory and the other criteria for evaluating the comparability of benchmarks "are just derived from applying the standard tools of economic analysis" that an economist "would apply to virtually any market," 5/12/08 Tr. 5794:18-5795:6 (Wildman), and that bargaining theory in particular is a "tool that economists will apply without necessarily writing articles on the theory of bargaining theory." 5/12/08 Tr. 5935:19-21 (Wildman). Over no objection from the Copyright Owners, this Court qualified Dr. Wildman as an expert in media economics. 5/12/08 Tr. 5779:17-5780:5 (Wildman). Moreover, Dr. Wildman has presented papers at several conferences applying bargaining theory to the cable television industry. 5/12/08 Tr. 5935:11-17 (Wildman). The Copyright Owners cannot concede that Dr. Wildman is an expert economist and then complain that he should not be allowed to testify about basic economic principles.

170. Turning to the merits of Dr. Wildman's testimony about the mastertone benchmark, the Copyright Owners attempt to take issue with his testimony that the division of the surplus negotiated for mastertones alone would differ systematically from the division that would likely occur if the parties were negotiating over mechanical rates for all forms of distribution of sound recordings simultaneously. CO PFF ¶ 518 (citing Wildman WRT at 29, RIAA Trial Ex. 87). But the best they can come up with is the assertion that this testimony lacks "empirical" support such as testimony from record company executives. CO PFF ¶ 518. Dr. Wildman explained in detail why, as a matter of economic theory, it makes no sense "to assume, as Dr. Landes does, that the observed split of mastertone surplus can be taken as a proxy for the split of surplus that would be determined by unconstrained negotiations over mechanical rights." Wildman WRT at 29, RIAA Trial Ex. 87. There is no basis for saying that this theoretical critique of Dr. Landes's assumption required empirical support.

171. The Copyright Owners go on to claim that Dr. Wildman admitted fatal flaws in his testimony that the negotiation of the mastertone rates in the NDMAs was affected by the fact that the publishers were already earning royalties on monophonic and polyphonic ringtones, which created an opportunity cost they had to consider and added to their leverage. CO PFF ¶ 46. But again, no such admission was made. First, the Copyright Owners say that Dr. Wildman "admitted that such a finding would hinge on a complete, complex analysis of, among other considerations, the cross-elasticity of demand of the two products—an analysis Dr. Wildman never performed." CO PFF ¶ 46 (citing Wildman WRT at 20, RIAA Trial Ex. 87); CO PFF ¶ 521. But what Dr. Wildman actually said was that a more complete analysis would be needed to *quantify* "the impact of this opportunity cost on the rate negotiated for mastertones." He added that "there can be little doubt that the rate publishers were able to negotiate for

mastertone rights was increased, and probably substantially, by the credible threat to refuse to license mastertones and continue to earn profits instead by selling ringtones only." Wildman WRT at 20, RIAA Trial Ex. 87. That is sufficient to undercut use of that rate as a benchmark.

172. The Copyright Owners then make much of Dr. Wildman's testimony that the opportunity cost of lost monophonic and polyphonic ringtone sales does not mean that the actual rate negotiated for mastertones had to be higher in absolute terms than the rate for ringtones, if the publishers anticipated a higher sales volume for mastertones. CO PFF ¶ 46 (citing 5/12/08 Tr. 5970-72 (Wildman)); CO PFF ¶ 522. They suggest this concession contradicts Dr. Wildman's "contention that publishers would have 'demanded a higher price.'" CO PFF ¶ 46. But there is, of course, no contradiction. Dr. Wildman's testimony was that the publishers would have demanded a higher price due to the opportunity cost *than they would have demanded in the absence of such a cost*. *See, e.g.*, 5/12/08 Tr. 5971:3-8 (Wildman) ("Q. All that it tells you is that in determining at what rate to license, the rate would have to be high enough to recover the opportunity costs of foregone monophonic and polyphonic sales, if any, correct? A. That is true."). Regardless of the absolute amount, this effect is enough to render the mastertone rate negotiated in the NDMAs an inappropriate benchmark for setting mechanical rates for situations in which no opportunity cost would affect the negotiations.

173. Equally unpersuasive is the Copyright Owners' attempt to rebut the fact that the NDMAs were package deals in which the record companies made concessions regarding the mastertone rate in return for major concessions on other products. CO PFF ¶¶ 523-528. They argue that the mastertone rates in the NDMAs are consistent with those in prior stand-alone agreements. CO PFF ¶ 524. But in fact they pointed to no prior agreement in which a record company agreed to pay 20% of wholesale or 10% of retail to a music publisher for the

mechanical rights associated with the sale of a mastertone. They point to hundreds of prior ringtone agreements in which *aggregators* agreed to pay about 10% of retail for the rights to use musical compositions. CO PFF ¶¶ 494-497, 501. But those agreements *did not involve record companies* or any splitting of royalties between sound recording rights and musical composition rights. Moreover, as Roger Faxon of EMI MP testified, those direct agreements between publishers and ringtone/mastertone providers were almost never implemented as to mastertones. Instead, virtually all licensing of mastertones has been done through the NDMAs. 1/30/08 Tr. 611:6-16 (Faxon).

174. Similarly, the Copyright Owners prove nothing from their reliance on two pre-NDMA agreements in which record companies agreed to sell mastertones on an "all in" basis for 50% of retail. CO PFF ¶ 501 (citing [ ]). Those downstream agreements do not establish any understanding on the part of the record companies about the relative value of sound recording and musical works rights for mastertones. The NDMAs were the first agreements in which record companies and publishers negotiated such a split.

175. The Copyright Owners also point to two post-NDMA standalone agreements in which record companies agreed to the same mastertone rates set forth in the NDMAs. CO PFF ¶ 502. But as Dr. Wildman explained, there is every reason to suppose that, by then, the NDMA agreements had become such a focal point that one cannot view these post-NDMA agreements as independent phenomena. 5/12/08 Tr. 5961:12-5962:15 (Wildman). Furthermore, one of the agreements cited by the Copyright Owners is an agreement between Warner Music Group and Peer for a total of four musical works, and the agreement states on its face that it is expressly "non-precedential." *See* Peer WDT at Ex. 151 at 1 & Schedule A, CO Trial Ex. 13 ("It is understood that the terms outlined in this License are deemed to be non-precedential; the terms

shall be inadmissible, and shall not be used to support any argument of law, in any litigation or arbitration or other proceeding that are of a similar nature or that concern similar issues, rights, works or materials."). The other of these agreements is an EMI-HFA agreement which has already been discussed in RIAA's Proposed Findings of Fact. *See* RIAA PFF ¶¶ 962-963.

176. Focusing on just one of the other products involved with the NDMAs, DualDisc, the Copyright Owners suggest that concessions were not necessary to allow sale of DualDiscs because that product was already on sale by the spring of 2004, before the NDMAs came along. CO PFF ¶ 525 (citing 2/20/08 Tr. 3977 (Wilcox)). But what Mr. Wilcox said was that SONY BMG was able to rely on controlled composition clauses for limited release of DualDiscs prior to the NDMAs. It took the NDMAs to make possible release of albums with compositions not subject to controlled compositions clauses. 2/20/08 Tr. 3977:12-3978:18 (Wilcox). As Mr. Wilcox testified, the inability to get to the market quickly with a full range of sound recordings on DualDiscs because of the publishers' refusal to license prior to the NDMAs was one reason why DualDisc failed as a commercial product. 2/20/08 Tr. 3960:14-3963:5 (Wilcox).

177. The Copyright Owners point out that the NDMAs were extended by three record companies after DualDisc had failed as a commercial product. CO PFF ¶¶ 526-528. But they fail to note that the NDMAs remained critically important for other reasons, particularly with regard to video products, which were very profitable for the record companies by the time of the NDMA extensions. 2/20/08 Tr. 4036:15-4037:5 (Wilcox); RIAA PFF ¶ 951. Indeed, Mr. Faxon testified that, under the extension, record companies continued to receive preferential terms on non-mastertone products and that the streaming video music business had become very lucrative for the record companies. 5/14/08 Tr. 6485:17-22 (Faxon) (admitting that the streaming video business covered by the NDMAs "has become a very large and lucrative business for the record

companies"). Moreover, the extensions of the NDMAs involved licenses for new rights that had not previously been licensed. *See* Faxon WRT at Ex. C at ¶¶ 2, 5 (Term Sheet for Video between EMI MP and Warner Music Group, dated August 2007), CO Trial Ex. 375 (extending NDMA and adding terms for user-generated videos). And the NDMA extensions changed the royalty rate terms for mastertones into *interim* rates that would be replaced by the decision ultimately rendered by this Court. CO Trial Ex. 73 at ¶ 10 (SONY BMG-EMI MP Amendment to NDMA, dated March 30, 2007).

178. The Copyright Owners dispute the notion that the mastertone market was viewed as a fleeting one at the time of the NDMAs. CO PFF ¶¶ 529-530. But the evidence is unequivocal that the record companies thought this product was a fad that would soon start to disappear. 2/20/08 Tr. 3959:12-3960:8 (Wilcox). Indeed, the Harry Fox Agency itself, at precisely the time when the NDMAs were being negotiated in 2005, published a forecast that mastertone sales would begin declining in 2008. Wildman WRT at RIAA Ex. 103-RR at 7, RIAA Trial Ex. 87; RIAA PFF ¶ 920. The Copyright Owners cite data from this forecast for only the year 2008, without noting that it projected declines starting in 2008 and continuing down into 2009. CO PFF ¶ 529. The prospect that this product would soon wither away was still another reason why the record companies were willing to accept the price demands of the publishers.

179. Moreover, the claim that mastertone sales are still growing and will continue to grow in the U.S. through 2012, based on the testimony of Claire Enders, is not to be believed. *See* CO PFF ¶ 48 (citing Enders WDT Ex. C at 6, CO Trial Ex. 10); CO PFF ¶ 530. Ms. Enders herself reported to her consulting clients in March 2007 that U.S. ringtone sales would grow only until 2009 and then start to decline. RIAA Trial Ex. 27 at 24. In fact, the evidence shows that

even this forecast, untainted by the need to support the Copyright Owners' case, was wildly optimistic. Abundant evidence shows that mastertone sales in this country are *already* declining sharply. RIAA PFF ¶ 922. Indeed, the music publishers' own representative, BMI, has reported that ringtone revenue as a whole has been declining in each of the last two years, as BMI had predicted, because lower-priced substitutional products were coming onto the market. Wildman WRT at Ex. 101-RP, RIAA Trial Ex. 87.

180. The Copyright Owners attempt to make the mastertone market seem significant enough to be a benchmark for the much larger market for sale of sound recordings. CO PFF ¶¶ 509-513. But the fact remains that mastertones are confined to a small percentage of the tracks sold as downloads ([ ] out of [ ] for EMI, and a smaller percentage of tracks on CDs, RIAA PFF ¶ 917), and the revenue they produce is tiny compared to other lines of business (for UMPG, [ ] in 2006 and [ ] in 2007, RIAA PFF ¶ 925[8]). Thus, Copyright Owners are attempting to use mastertone rates applied to a small number of very valuable, popular sound recordings to set rates for CDs and digital downloads for all sound recordings.

181. Remarkably, the Copyright Owners even dispute the testimony of the RIAA experts that mastertones are used by consumers for a different purpose than sound recordings intended for entertainment. CO PFF ¶ 514 ("Nor is there any empirical evidence to support the argument that mastertones primarily serve a social 'signaling' function, unlike other uses of recorded music.") But economic experts are allowed to rely on common sense, a product's characteristics, and the products that compete with it in drawing their conclusions. Slottje WRT at 19, RIAA Trial Ex. 81. This is such a case.

[8] RIAA inadvertently stated in its Proposed Findings of Fact that these figures ([ ] in 2006 and [ ] in 2007) referenced the percentage of ringtone revenue at Universal Music Group when, in fact, these numbers reference Universal Music Publishing Group data. *See* RIAA PFF ¶ 925.

182. Attempting to mitigate the fact that mastertones sell for more than twice the price of full downloads, the Copyright Owners make two weak points. They say that *mobile* downloads are priced more like ringtones. CO PFF ¶ 515. As an initial matter, this Court recognized in the SDARS proceeding that, whatever the premium for downloads to cellular phones (Dr. Ordover's "immediacy" adjustment), that premium appears to be disappearing from the marketplace. *See SDARS Decision,* 73 Fed. Reg. at 4093. In any event, downloads on iPods are just as mobile as mastertones, but are priced much less than a mastertone. There is no reason to believe that the mechanical rate for mastertones can be applied without adjustment to a product with such a different retail pricing structure. RIAA PFF ¶ 907. The Copyright Owners also say that the price of downloads may be suppressed in order to sell more iPods. CO PFF ¶ 516. But even if that were true, it would not rebut the economists' testimony that the two products have very different supply and demand characteristics. If anything, this claim further supports the argument that these differences cannot be ignored.

183. Finally, the Copyright Owners dispute Dr. Wildman's testimony that the NDMA rate is an unreliable benchmark because, for most of the sound recordings being distributed, the costs of production and marketing were long ago sunk. CO PFF ¶ 519 (discussing Wildman WRT at 29, RIAA Trial Ex. 87). Without citation, they claim that this Court has rejected this argument twice before. CO PFF ¶ 519. And they claim that Dr. Wildman gave contrary testimony in *Webcasting I.* CO PFF ¶ 519.

184. That is incorrect. What this Court has previously rejected is treating costs as sunk in setting the price of a particular method of distributing sound recordings that will be created in the future, such as interactive and non-interactive webcasting. *E.g.*, *Webcasting II*, 72 Fed. Reg. 24084, 24094 (2007). That was precisely the point Dr. Wildman made in *Webcasting I*,

distinguishing that situation from the synch rights marketplace, where negotiations do occur after costs are sunk. 5/12/08 Tr. 5947:15-5950:11 (Wildman). *See* RIAA PFF ¶¶ 865-870. With regard to the NDMAs, which were short-term, first-time blanket licenses, Dr. Wildman made the point in his testimony that costs were sunk for most of the recordings to which those agreements applied, and that could have affected the rate negotiated. Wildman WRT at 29, RIAA Trial Ex. 87. That does not mean he would urge the Court to ignore costs as sunk in pricing royalties for mastertones or other forms of delivery of sound recordings going forward. Indeed, with respect to CDs and digital downloads, when the mechanical license is negotiated, record companies have sunk none of the costs of creating, marketing, and distributing the single sound recording that will be the subject of the mechanical license.

185. Even if the NDMAs could provide a valid basis for setting mechanical rates in this proceeding, it would make no sense to base the rates on the 20% of wholesale figure in the NDMAs. Doing so would artificially inflate the rate in those markets where the relationship between wholesale and retail differs from in the mastertone market. Thus, even if the Court were to wholly accept the Copyright Owners' ringtone benchmark, as Roger Faxon agreed, it would make more sense to rely on the 10% of retail figure in the NDMAs, RIAA PFF ¶¶ 965-966, and only from that figure make appropriate adjustments downward consistent with the four statutory factors.

186. In sum, the mastertone benchmark does not even come close to satisfying any reasonable test of the comparability of a benchmark. This Court should reject it.

C. Synchronization Rights

187. The Copyright Owners have failed to establish that the synchronization rights market is sufficiently comparable to serve as a useful benchmark. *SDARS Decision*, 73 Fed.

Reg. at 4088 (stating that "comparability is a key issue in gauging the relevance of any proffered benchmarks" and that "potential benchmarks are confined to a zone of reasonableness that excludes clearly noncomparable marketplace situations"). While the Copyright Owners rest this benchmark exclusively on the theoretical musings of Professor Landes, RIAA presented marketplace evidence about how the synchronization market actually operates. That evidence establishes that the synch rights market is decidedly noncomparable to the market for mechanical rights: it involves different buyers (music supervisors for movies, television shows and advertisements) buying different rights for different purposes (the rights to use musical works and sound recordings as secondary features of audiovisual works), under circumstances where the relative leverage of the publishers and record companies is skewed in favor of the publishers and at a time when the costs that would be taken into account are entirely different than in the context of mechanical licensing. *See* RIAA COL ¶ 61.

188. These basic differences render synchronization rights a completely inapposite benchmark. It is therefore not surprising that arguments about the equivalency of musical works and sound recording rights in the synchronization market have not fared well in this Court in previous proceedings. The Copyright Owners, however, conveniently ignore the fact that this Court has twice previously rejected the argument that, based on the synchronization rights market, sound recordings and musical works should be valued the same. *See* RIAA PFF ¶ 828; RIAA COL ¶ 147. Nor do the Copyright Owners offer any reason for this Court to revisit its judgment that synchronization rights are not a useful benchmark.

189. The Copyright Owners try to prop up the synchronization rights benchmark by launching preemptive attacks on some, but not all, of RIAA's critiques. Those attacks are to no avail. First, in response to Mr. Pascucci's testimony that competition among sound recordings in

the synch market places downward pressure on the master use fees that record companies can obtain, the Copyright Owners argue that there are "symmet[rical]" competitive pressures on the prices that can be obtained for musical works. To support this theory, they cite Dr. Landes's testimony that "'[f]ew songs are so unique that a commercial or movie can use only that song to convey a particular message.'" CO PFF ¶ 538. But Dr. Landes's theoretical speculation about how the market might operate is refuted by RIAA's evidence from a knowledgeable fact witness about how the market actually does operate in real life. As Mr. Pascucci explained, music supervisors for movies, television shows and advertisements do in fact often seek to use a particular song for their project, thereby diminishing a record company's leverage considerably. *See* RIAA PFF ¶¶ 851-855. And notwithstanding the Copyright Owners' skepticism about the threat of re-recordings of songs placing further downward pressure on master use fees that record companies receive, *see* CO PFF ¶ 538, the evidence from the marketplace establishes that the threat is real and common. *See* RIAA PFF ¶¶ 853-855 (credible threats of re-recordings arise about once a week at Rhino).

190. Second, the Copyright Owners claim that RIAA failed to present "evidence that record companies would do anything less than seek to maximize their share of synchronization revenue." *See* CO PFF ¶ 537. But this assertion is refuted by evidence in the record that record companies sometimes have other objectives, such as promotion, when they negotiate master use licenses. Mr. Pascucci, who has direct experience negotiating mechanical licenses and synch/master use licenses, explained that in negotiating master use licenses, record companies are sometimes "very focused on maximizing promotional opportunities," and not simply on maximizing revenue from master use licensing. 5/7/08 Tr. 5277:21-5278:2 (Pascucci). In other words, a record company may have a strong incentive to issue a master use license, even at a

reduced price that fails to maximize synchronization revenue, if the television show or movie will promote CD sales and thus generate other revenue. As Mr. Pascucci explained, master use licensing can help promote and reignite interest in recordings and is thus "good for sales of the album." 5/7/08 Tr. 5303:3-5304:4 (Pascucci). *See* RIAA PFF ¶¶ 863-864. This is particularly true for older songs. Mr. Pascucci agreed with Judge Roberts' observation that in the synch rights context many of the songs are older and "it's sort of a new life, a new lease on life for these songs to be licensed to audiovisual works." 5/7/08 Tr. 5309:22-5310:18 (Pascucci) (quoting Judge Roberts).

191. Furthermore, the Copyright Owners' theory about record companies' seeking only to maximize revenue in the synchronization market ignores the evidence that for many years master use licensing "was an ancillary source of revenues" that record companies did not focus on as much, and "that is part of why perhaps some of the practices that evolved over the last 40 years in this area are different than other parts of the business, because they've evolved off to the side." 5/7/08 Tr. 5310:20-5311:14 (Pascucci). *See* RIAA PFF ¶ 870.

192. Third, the Copyright Owners appear to dispute the testimony of Dr. Wildman that the negotiations for synchronization royalties occur long after costs for a particular recording have been sunk. The Copyright Owners fail to point to any basis in the record to cast doubt on this straightforward proposition; instead, they merely claim that Dr. Wildman did not conduct an empirical study. *See* CO PFF ¶ 537. But common sense and the evidence demonstrate that Dr. Wildman is correct: unlike mechanical royalties, synchronization royalties are very often negotiated after costs have been sunk. As Mr. Pascucci explained, the average age of the songs for which Rhino issues master use licenses is approximately 20 to 25 years old. 5/7/08 Tr. 5308:11-5309:15 (Pascucci). The costs for recording those songs, of course, were incurred long

ago, confirming Dr. Wildman's testimony. *See* RIAA PFF ¶¶ 866-870. Moreover, at the time that the original sound recording is created, it is impossible to predict whether it will ever earn synchronization revenues. *See* RIAA PFF ¶¶ 866-870.

193. Fourth, the Copyright Owners seem to contend that the fact that sound recordings are just a secondary input in audiovisual works in the synch context (as opposed to the primary product made available to the public in the mechanicals context) is irrelevant to determining whether synch rights is an appropriate benchmark. The Copyright Owners again refer to an alleged failure by RIAA to provide "empirical evidence" on this point. *See* CO PFF ¶ 540. But an empirical study is not needed to confirm the basic facts that music is only one input in a movie or television show, that music typically serves a secondary purpose in movies and television shows, that consumers do not actually purchase background music in movies and television shows, and that demand for a recording in the synch market is driven in part by a song's past performance. *See* RIAA PFF ¶¶ 840-848. Nor can there be any serious dispute that, as Dr. Wildman observed, these facts lead to the conclusion that demand for recordings in the synch market is different from consumer demand for recordings in the sound recording market—a fundamental difference that Dr. Landes and the Copyright Owners fail to adjust for and that disqualifies the synch rights market from serving as a benchmark in this proceeding. *See* RIAA PFF ¶¶ 844-846.

194. Finally, in addition to the discussion above, the Copyright Owners simply ignore the other reasons that, as the evidence shows, synchronization rights are a poor benchmark. *See* RIAA PFF ¶ 827 (the 50-50 division of royalties is unlike the split in all markets where mechanical royalties are paid); ¶ 843 (budget constraints and competition in the synch/master use market push down the price for recordings); ¶¶ 849-852 (publishers have more leverage in the

synch/master use market); ¶¶ 857-859 (music production libraries or other recordings can substitute for recordings in the synch/master use market); ¶¶ 860-862 (artists have incentives to inflate synch payments at the expense of master use payments); ¶¶ 871-872 (the Copyright Owners synch benchmark would lead to absurd results).

195. In sum, there is overwhelming evidence that the synchronization market is not comparable to the mechanicals market, and just as this Court held in prior cases, the equivalent compensation that musical works and sound recordings receive in the synchronization market provides no useful information for setting a rate in this proceeding.

D. The AHRA

196. The Copyright Owners devote a scant three paragraphs of their findings to their AHRA benchmark, *see* CO PFF ¶¶ 52, 541-542, and with good reason as this so-called benchmark is utterly irrelevant to the Court's analysis. The Copyright Owners fail to explain why a piece of legislation from 1992, as opposed to a marketplace agreement, should be used as a benchmark or how it is in any way comparable to the market for mechanicals. *SDARS Decision*, 73 Fed. Reg. at 4088 (stating that "comparability is a key issue in gauging the relevance of any proffered benchmarks" and that "potential benchmarks are confined to a zone of reasonableness that excludes clearly noncomparable marketplace situations"). As RIAA has previously explained, there are numerous and fundamental ways in which the AHRA is not a comparable benchmark. *See* RIAA COL ¶ 156.

197. The Copyright Owners also completely ignore the AHRA's legislative history which makes clear that the AHRA's allocation of royalties is the result of a compromise related to copyright protection technology for digital audio tapes and immunity for device manufacturers, and was not intended to reflect marketplace rates. *See* RIAA PFF ¶¶ 873-884.

198. In support of this benchmark, the Copyright Owners cite little more than some vague assertions by Professor Landes about the "economic analysis of law" as supporting the use of legislation as a benchmark, *see* CO PFF ¶ 542, but these claims are woefully unclear and fall far short of explaining why legislation related to a noncomparable market should play any role is setting the mechanical rate.

E. Dr. Landes Failed to Consider Adjustments to His Benchmark Rates and the One Adjustment He Did Make, He Did Incorrectly.

199. As this Court has held in its two prior cases, a benchmark rate may nonetheless need to be adjusted in order to set a royalty rate for a different market. Indeed, Dr. Landes himself recognized the need to make these very adjustments when he calculated the royalty rate for CDs at a level lower than that for digital downloads; in so doing, Dr. Landes explained that it was appropriate to reduce the "content pool" to reflect the investments of record companies in manufacturing and distribution. But, without explanation, Dr. Landes failed to reduce the content pool to reflect the investments in A&R, marketing and other expenses incurred by record companies and not by publishers. RIAA PFF Section IV.D.8.

200. As shown by Dr. Wildman, even if one were to accept Dr. Landes's ringtone benchmark, which is based fundamentally on a surplus analysis, it would be necessary to make significant adjustment to reflect the differences in cost and demand between the two markets. Dr. Wildman provided two approaches for making such an adjustment, resulting in mechanical royalties from between 6 and 8.1 cents per track (or equivalent wholesale percentages). RIAA PFF Section IV.D.8.

IV. THE COPYRIGHT OWNERS HAVE PAINTED A DISTORTED PICTURE OF EXISTING AND FORECAST ECONOMIC CONDITIONS.

201. The impression one gets from reading the Copyright Owners' Proposed Findings of Fact is completely at odds with reality in the recorded music industry. The great weight of the evidence presented at trial demonstrated that the record companies are facing their most difficult times in memory, while songwriters' incomes have grown much faster than the rate of inflation since 2003 and music publishing companies have experienced steady growth and expansion.

A. Songwriters

202. The Copyright Owners repeatedly contend that the songwriters "received barely a mention" by RIAA in this proceeding, *see, e.g.*, CO PFF ¶¶ 6, 218. That is plainly untrue, as RIAA presented extensive testimony about the economic conditions, incentives, and relative contributions of songwriters with respect to the Section 801(b) factors. *See, e.g.*, Slottje WRT at 22-26, RIAA Trial Ex. 81; Wildman WRT at 31-44, RIAA Trial Ex. 87. Moreover, it is ironic that the Copyright Owners accuse RIAA of ignoring the songwriters in this proceeding given that RIAA is the *only* party in this proceeding to offer market benchmarks involving songwriters. *See* RIAA PFF Section III.C. Not a single one of the Copyright Owners' benchmarks is an agreement between a songwriter and another party. Rather, the Copyright Owners only advance benchmark agreements between music publishers and other corporations. The Copyright Owners cannot have it both ways, arguing that "songwriters represent the true economic interest at issue in this dispute," CO PFF ¶ 6, yet failing to offer any economic benchmark demonstrating what songwriters agree to receive for their songs in the marketplace. If the true economic interest at issue in this proceeding is that of songwriters, then the Court should accept the benchmarks advanced by RIAA and Professor Wildman in this proceeding.

203. Moreover, the Copyright Owners exaggerate when they say that songwriters "typically receive 75%—and sometimes as much as 95%—of the mechanical royalties earned from the exploitation of their musical compositions." CO PFF ¶ 218. Terri Santisi's analysis of the publisher financials for UMPG, Sony/ATV and EMI MP showed that in 2006, publishers retained a minimum of [█████] (UMPG) and a maximum of [█████] (Sony/ATV) of the mechanical royalties they earned. RIAA PFF at Table B at pp. 663-665. That means that, at most, only about [█████] of mechanical royalties earned in that year were actually paid out by publishers in the form of royalties.[9] And not all of these royalties went to songwriters. As Terri Santisi explained, some portion of the mechanical royalty payments shown on Table B is paid to other publishers, either due to subpublishing agreements or catalog administration deals. 5/7/08 Tr. 5206:8-11 (Santisi). Thus, on average, songwriters probably earn well under 70% of mechanical royalties.

204. In any event, the Copyright Owners' own testimony demonstrates that the songwriters have had significant success, certainly as compared to record companies, and even as record sales and record prices continue to decline. Professor Landes concluded that songwriters' royalty income, both from mechanical royalties and total royalties, increased faster than the rate of inflation from 2003 to 2006. He also testified that the songwriters who are actually the "true economic interest" in this proceeding are a relatively small group of extraordinarily successful writers who, in writing songs to be recorded by record companies, put very little at risk yet have a substantial amount to gain.

1. The Myth of the Middle-Class Full-Time Songwriter Who Lives on Mechanical Royalties

[9] It also means that the Copyright Owners' accusation that RIAA "instructed" Ms. Santisi to leave songwriters out of her analysis is not only irrelevant, but it is also false. *See* CO PFF ¶ 768.

205. The Copyright Owners' Proposed Findings of Fact center on the need to increase the compensation of a typical middle-class, full-time songwriter who lives and depends on mechanical royalties to make a living. That person is a myth. Even the writer witnesses that the Copyright Owners presented at trial did not hold true to this stereotype—they were performers with either current or multiple past record deals (Sharp, Shaw, and Galdston), trade association executives (Carnes, Bogard), and a classical composer who makes his living primarily from commissions, not mechanical royalties (Paulus). *See* RIAA PFF ¶ 81.

206. Testimony from music publishing executives confirmed that full-time songwriters are quite rare. Their testimony was that 90% of songwriters on their current rosters are either singer-songwriters or producer-songwriters, not pure full-time songwriters. *See* RIAA PFF ¶ 81 (citing testimony from, among others, Firth, Robinson, and Peer). The Copyright Owners attempted to back away from this testimony in their Proposed Findings of Fact, dramatically understating the phenomenon. CO PFF ¶ 224 ("Sometimes, songwriters participate in other aspects of the music industry to make a living."). Yet the unrebutted testimony of their own witnesses is that the vast majority of songwriters are *not* pure songwriters, but rather are singer-songwriters and producer-songwriters who participate in multiple aspects of the music business.

207. The notion of a full-time, middle-class songwriter is also a myth for an additional reason: successful songwriters are earning incomes that place them well above anything that could be described as "middle-class," while unsuccessful songwriters generally are earning very little. The evidence showed when a songwriter is successful, he or she receives astronomical amounts of mechanical royalties, on top of performance and synchronization royalties and in addition to separate royalties earned as a recording artist (for the singer-songwriters) and as producer fees (for the producer-songwriters). In Professor Landes's songwriter study, the top 1

percent of songwriters (about 95 out of a list of about 9,500 in the dataset studied) earned about *half* of the total mechanical earnings of the profession each year. 5/20/08 Tr. 7338:4-10 (Landes). The earnings of this top 1% all exceeded $449,000—often reaching the many millions of dollars per year. 5/20/08 Tr. 7337:10-7338:3, 7346:17-20 (Landes). And even these earnings were understated significantly by Dr. Landes for numerous reasons brought out at trial. *See* RIAA PFF ¶¶ 533-538.

208. The myth of the full-time, middle class songwriter who depends on mechanical royalties for a living is also fictional because the number of writers who actually depend entirely on mechanical royalties for a living is close to zero. Professor Landes conceded that "the vast majority of people are earning less than $10,000" in *total* royalties per year, much less mechanical royalties, and most of them are earning much less than $10,000. 5/20/08 Tr. 7348:5 (Landes); Landes WRT ¶ 18, CO Trial Ex. 406. Among the approximately 9,500 songwriters he studied, 5,179 (or approximately 54%) averaged about $150 or $200 in annual mechanical income over the period 2000-2007. 5/20/08 Tr. 7338:11-7341:5 (Landes); Landes WRT ¶ 16, CO Trial Ex. 406. Certainly, these writers do not depend on mechanical royalties for a living. Professor Landes conceded that these individuals are presumably earning their income from other endeavors. *See* Landes WRT at 10 n.13, CO Trial Ex. 406.[10] It would be a perverse

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[10] Professor Landes attempted to depict a larger percentage of writers as dependent on mechanical royalties in Figures 8 and 9 of his written rebuttal testimony, but this data is virtually meaningless. As Judge Roberts pointed out, while the largest group represented in Figure 8 is the group of writers for whom mechanical royalties represent 95-100% of royalties earned, the second-largest group is those writers for whom mechanical royalties represent 0-5% of royalties earned. 5/19/08 Tr. 7227:3-7230:2 (Landes). Thus, Professor Landes testified that a writer earning less than $2.00 in total royalties could as easily be placed in the 95-100% column as the 0-5% column, depending on whether the $2.00 in total royalties happened to be mechanical royalties (in which case the writer would land in the 95-100% column) or performance royalties (in which case the writer would land in the 0-5% column). 5/19/08 Tr. 7227:3-7230:2 (Landes).

interpretation of the § 801(b) factors—particularly the second factor requiring "fair" compensation—to increase the mechanical rate in order to guarantee a higher level of compensation to these songwriters, who are empirically unsuccessful at writing songs that appeal to consumers and thus have learned to earn their income elsewhere.

209. The arguments of the Copyright Owners with respect to songwriters are thus dependent on fiction. They argue that the mechanical rate should be increased so that this nonexistent average songwriter may lead a comfortable middle class existence solely earning mechanical royalties. That is an impossible goal, given the way the songwriter market functions, and one that finds no support in the evidentiary record or the statutory factors.

2. Songwriter Income Is Increasing, Not Decreasing.

210. Even if one were to accept for the sake of argument the view that songwriter income should govern the rate set in this proceeding, the evidence suggests that songwriter income has grown steadily over the past five years even as record sales and record prices have declined. Although the Copyright Owners would like to argue that songwriters' royalty income is decreasing, their own evidence indicates that is not the case. In his rebuttal testimony, Professor Landes presented a songwriter study. Notwithstanding numerous substantial and systemic methodological flaws which resulted in the understating of writer income over the period in question, *see* RIAA PFF ¶¶ 533-538, that study demonstrated that songwriter royalty income has increased faster than the rate of inflation in every year since the year 2003.

211. Figure 2a of Professor Landes's songwriter study demonstrates that for the full songwriter sample analyzed in his study, average *mechanical* royalty income increased *faster than the rate of inflation* in every year since the year 2003. Landes WRT at Fig. 2a, CO Trial

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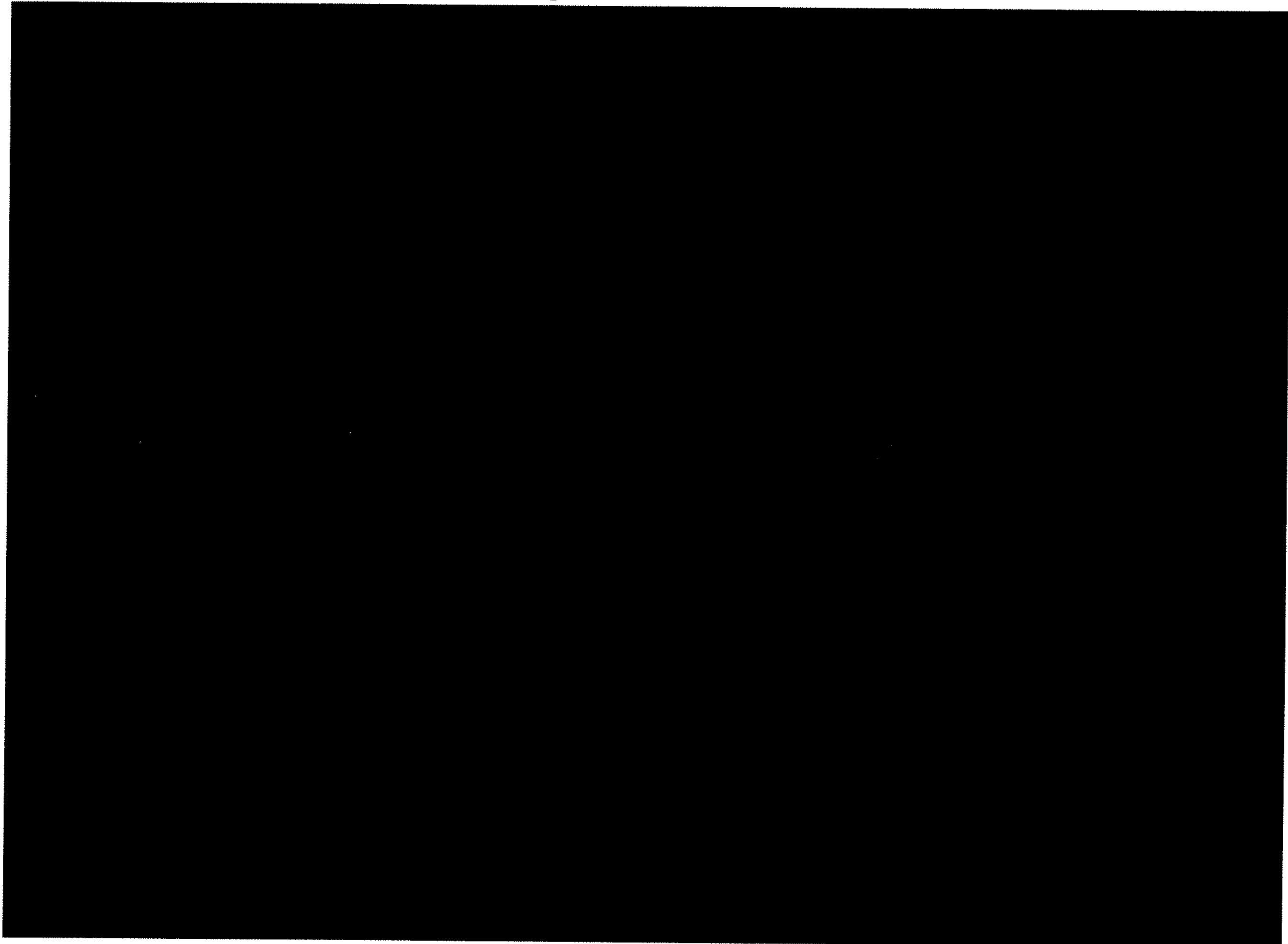
In either scenario, however, the writer in question is certainly not depending on $2.00 in total royalties earned for his or her living.

Ex. 406. Figure 4a of Professor Landes's songwriter study demonstrates that for the full songwriter sample analyzed in his study, average *total* royalty income likewise increased *faster than the rate of inflation* in every year since the year 2003. Landes WRT at Fig. 4a, CO Trial Ex. 406. Although the Copyright Owners state in their Proposed Findings of Fact that "**Total Income Is Falling**," CO PFF at 93, Professor Landes's figure shows a very different story:

RPFF Figure 1 - RESTRICTED



See RIAA PFF Figure 54 (Landes WRT at Figure 4a, CO Trial Ex. 406). In no sense whatsoever does this Figure depict a trend of falling total income, notwithstanding the Copyright Owners' attempts to portray it as such. Importantly, Dr. Landes's figure represents 2007 dollars, so a horizontal line would reflect stable growth at the rate of the increase in the CPI, and the growth depicted substantially outpaces inflation since the year 2003.

212. The Copyright Owners devote a section of their Proposed Findings of Fact to the fact that piracy has harmed songwriters (though they do not attempt to quantify this harm). *See* CO PFF ¶¶ 236-240. That songwriter income has increased faster than inflation, even in the face of the harm caused by music piracy, is truly astonishing.

213. The Copyright Owners focus in their Proposed Findings of Fact on the data from a subgroup of Professor Landes's full songwriter sample, but present no reason why this subgroup is more representative of the compensation of songwriters in general than the full songwriter sample. Nor did Professor Landes testify to that effect at trial. In fact, it is quite evident that this subgroup is *less* representative since the songwriter subgroup does not include the top 1 percent of songwriters, even though this group earned about half of the total income earned by all the songwriters in the study. 5/20/08 Tr. 7338:4-10 (Landes). If the parties earning the most mechanical royalties are the "true economic interest at issue," as asserted by the Copyright Owners in their own Proposed Findings of Fact, *see* CO PFF ¶ 6, then excluding the songwriters who earn half of the total income at issue results in a less accurate depiction of that economic interest than results from including them. And, as has already been explained, the earnings trend of songwriters, when the highest earners are included, is one of consistently *rising* royalty income since 2003.

3. The Fact That Songwriters Voluntarily Agree to Controlled Composition Clauses Is Not a Valid Basis for a Rate Increase.

214. The Copyright Owners argue that songwriters' mechanical royalties are declining —and that the rate should be increased—because of "the increased use by record companies of controlled composition clauses." CO PFF ¶ 235; *see also* CO PFF Section IV.C.2(b). Yet controlled composition clauses are elements of voluntarily negotiated agreements between record companies and singer-songwriters. Throughout this proceeding, the Copyright Owners have ignored the fact that these clauses are not "imposed on" writers by record companies. Rather, they are contained in agreements negotiated and signed voluntarily by singer-songwriters. *See* CO PFF ¶ 243 (citing songwriter testimony that controlled composition clauses are negotiations between record companies and songwriters). Moreover, the increased use of such clauses simply

reflects the urgent need of record companies to reduce their mechanical royalty burden in the face of declining revenues and prices.[11]

215. In fact, although the Copyright Owners cite testimony from certain of their songwriter witnesses who agreed to controlled composition clauses, they omit from their Proposed Findings of Fact the testimony of another of their songwriter witnesses, Phil Galdston, who testified that he was able to resist the signing of a controlled composition clause. 1/30/08 Tr. 800:11-13 (Galdston) (testifying that he himself has been able to resist them). They also omit the testimony of the President of the NMPA, David Israelite, who testified that "when an artist reaches a certain level, that a few of them do have the power to reject" controlled composition clauses. 2/5/08 Tr. 1450:21-1451:10 (Israelite). Thus it is simply incorrect for the Copyright Owners to suggest in their Proposed Findings that songwriters "lack any real alternative to accepting controlled rates." CO PFF ¶ 249.

216. Moreover, the Copyright Owners have not presented any legal argument in this proceeding that controlled composition clauses or artist contracts are contracts of adhesion, nor would such an argument succeed. *See, e.g.*, *Reznor v. J. Artist Management, Inc.*, 365 F. Supp. 2d 565, 577 (S.D.N.Y. 2005) (in challenge by rock star Trent Reznor, court held: "While it is possible that Reznor could have commanded more favorable terms had he driven a tougher bargain, there is no admissible evidence that the objected-to provisions in the management agreement were unusual for the industry, let alone that they violated any public policy. Indeed, all indications are that Toorock provided a contract in which most provisions were standard. On the basis of this record, no reasonable court could find these provisions unconscionable as a

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[11] DiMA's arguments concerning the relevance of controlled composition clauses merely attack the Copyright Owners' arguments that controlled composition clauses provide a justification for raising the rates and have no bearing on the relevance of controlled composition clauses as a benchmark. DiMA PFF ¶¶ 261-264.

matter of law."). And, in any event, as Chief Judge Sledge observed, any argument that artist contracts are contracts of adhesion is simply irrelevant to this proceeding. 2/5/08 Tr. 1419:2-5, 1420:9-12 (explaining that that is "a contractual matter" which is "for others than us"). Certainly, recording contracts with controlled composition clauses are no more contracts of adhesion than the contracts music publishers sign with songwriters that contain numerous protections for the publishers. *See* RIAA PFF Section II.E.3.c.

217. To the extent the Copyright Owners are seeking an increase in the mechanical rate due to the increasing frequency of controlled composition clauses, they are seeking a rate increase due to marketplace agreements *they themselves have signed.* In essence, the Copyright Owners are asking the Court to save songwriters from themselves. *See* CO PFF Section IV.C.2.(b); CO PFF ¶ 249. Nothing in the factors set forth in Section 801(b) permits this demand that the Judges not only ignore marketplace agreements, but in fact *counteract* those agreements by increasing the mechanical rate to compensate for voluntary discounts agreed to by the Copyright Owners.

218. Moreover, to the extent that controlled composition clauses have become more prevalent, that increasing prevalence merely indicates the market value of songs in a time when mechanical rates were increasing pursuant to the 1997 Agreement. As the Copyright Owners themselves explain, songwriters who sign these agreements receive "often significantly lower than 9.1 cents per song." CO PFF ¶ 243. To the extent that songs are earning less in the market than was assumed when the 1997 agreement was signed, the increasing prevalence of controlled composition clauses warrants a *decrease* in the mechanical rate, not an increase. *See* RIAA PFF Sections III.B.3 & III.C.

219. Finally, to the extent that controlled composition clauses reduce songwriter compensation, this will become less frequent as more music is sold digitally. *See* RIAA PFF ¶¶ 1102, 1124. The Copyright Owners suggest to the contrary, citing one record company witness's testimony that for DPDs released pursuant to artist agreements that post-date June 22, 1995, her company pays the full statutory mechanical rate on net sales, instead of on gross sales. CO PFF ¶¶ 10, 253-256. There is no evidence in the record about how frequently other record companies' agreements permit payment on a net-sales basis, or how frequently such contractual language is applied.

220. Although the Copyright Owners suggest that payment on a net-sales basis may contravene Section 115(c)(3)(E), CO PFF ¶ 255, that issue is totally irrelevant here. Whether mechanical royalties for post-1995 DPDs may or may not be paid on a net-sales basis pursuant to voluntary agreements should have no effect on this Court's setting of a statutory mechanical rate.

221. In any event, it does not appear that payment on a net-sales basis contravenes any statutory requirement. For pre-1995 and post-1995 DPDs alike, SONY BMG sometimes reduces the number of units for which it pays the full statutory mechanical royalty rate by paying royalties on net sales instead of gross sales. This reduces the number of units for which SONY BMG pays mechanical royalties by about 15%. 5/12/08 Tr. 5736:14-17 (A. Finkelstein) ("So this would define the unit base on which we pay, which is one of the terms that we understand to still be available to us."). When SONY BMG pays mechanical royalties on net sales instead of gross sales for DPDs that are the subject of post-June 22, 1995 recording agreements, it still pays the full statutory mechanical rate as required by Section 115(c)(3)(E). *See* 5/12/08 Tr. 5735:4-6 (A. Finkelstein) ("Well, we're paying on the rates that are the statutory rates, we're paying on the lower units as allowed under the agreement.").

222. Section 115(c)(3)(E) does not, by its terms, prohibit limiting the number of units upon which mechanical royalties are paid for post-1995 DPDs. Nor does it bar application of all aspects of controlled composition clauses for post-1995 DPDs. Rather, it provides that statutory royalty rates trump the royalty *rates* contained in controlled composition clauses in recording contracts entered into after June 22, 1995: "royalty rates determined pursuant to subparagraph (C) and (D) [of Section 115] shall be given effect as to digital phonorecord deliveries in lieu of any contrary royalty rates specified in a contract." 17 U.S.C. § 115(c)(3)(E). This provision thus does not prevent a record company from enforcing non-rate provisions of controlled composition clauses for tracks that are the subject of post-1995 recording contracts. *See, e.g.*, 5/12/08 Tr. 5732:12-21 (A. Finkelstein) (explaining that for post-1995 DPDs, terms of controlled composition clauses such as audit rights remain in effect).

223. The payment of mechanical royalties on a net-sales basis was not included in SONY-BMG's contracts to make an end-run around Section 115(c)(3)(E). As Ms. Finkelstein explained, "This is not a new provision in the agreement, this has been in the agreements for about 25 years." 5/12/08 Tr. 5736:12-14 (A. Finkelstein).

224. Nor does payment on a net-sales basis "contradict Ms. Finkelstein's prior testimony in this proceeding," as the Copyright Owners suggest. CO PFF ¶ 256. Ms. Finkelstein correctly and consistently testified that for post-1995 DPDs, SONY BMG loses the benefits of reduced rates in controlled composition clauses. For DPDs that are the subject of a *pre*-1995 recording agreement, SONY BMG: (a) may pay a controlled mechanical rate that is 75% of the statutory rate; (b) may cap the number of songs for which it pays mechanical royalties; and (c) may pay mechanical royalties on net sales (85% of gross sales). By contrast, for DPDs that are the subject of a *post*-1995 recording agreement, SONY-BMG: (a) may pay

100% of the statutory mechanical rate; (b) may not cap the number of songs for which it pays mechanical royalties; and (c) may pay mechanical royalties on net sales (85% of gross sales). 5/12/08 Tr. 5737:1-5738:1 (A. Finkelstein) (answering "yes" to Judge Roberts' questions whether (1) SONY BMG used the contractual provision to pay royalties on 85 percent of gross sales and the reduced rate provision of the controlled composition clause prior to 1995, and (2) after 1995 SONY BMG still uses the provision to pay royalties on 85 percent of gross sales, but does not use the reduced rate provision of the controlled composition clause). Thus, pursuant to Section 115(c)(3)(5), SONY BMG still makes a much larger mechanical royalty payment for a post-1995 DPD than for a pre-1995 DPD, since the effects of the 25% discount and cap dwarf the 15% net sales deduction.

4. The Fact That Songwriters Voluntarily Agree to Share Royalties with Co-Writers and Music Publishers Is Not a Valid Basis for a Rate Increase.

225. The Copyright Owners also suggest that songwriters deserve a rate increase because the amount they receive in mechanical royalties is reduced when songwriters co-write with other songwriters or artists. CO PFF ¶ 243. This is yet another example of the Copyright Owners asking the Court to save the songwriters from themselves. Songwriters *voluntarily* co-write with other writers. It is a choice that songwriters make in the marketplace. 1/28/08 Tr. 217:1-218:1 (Carnes) (explaining that "the marketplace reality" is to co-write); 1/31/08 Tr. 881:16-882:6 (Sharp) (explaining her voluntary decision to co-write with other songwriters). There is nothing in Section 115 or in the Section 801(b) factors justifying an increase in the mechanical rate based on songwriters' own decisions to share royalties with other songwriters.

226. Moreover, the Copyright Owners suggest that songwriter compensation should be increased because songwriters earn less after the music publishing companies take their share of

the royalties from songwriters. *See, e.g.*, CO PFF ¶ 232 (stating that a song that goes platinum "may generate only about $20,000 in mechanical royalties for a songwriter after co-writers and publishers receive their shares"). As with co-writers, how the music publishers and songwriters choose to carve up mechanical royalties earned by a song is irrelevant to the rate set under the Section 801(b) factors. Moreover, there is no assurance that if the mechanical rate were increased, music publishers would not simply capture a larger share of mechanical royalty payments rather than share them with songwriters. In short, the fact that songwriters may share mechanical royalties with other writers or with music publishing companies is not a valid basis for seeking an increase in the mechanical royalty rate.

5. The Copyright Owners' Repeated Suggestions That Songwriters Earn Little Mechanical Royalties Are Belied by the Fact That Songwriters Receive Substantial Advances on their Royalties.

227. The Copyright Owners make much of the fact that the songwriter witnesses in this proceeding repeatedly testified that they received "only" a certain amount of mechanical royalties for a hit song. *See* CO PFF ¶ 232. For example, Maia Sharp testified that she received "only" $12,000 for a hit song that sold over six million copies. She explained that she received "only" $12,000 in part because she had to share royalties with her music publisher and her co-writer (who happened to be her father). *Id.*; Sharp WDT at 5-6, CO Trial Ex. 6. But she failed to explain that she received "only" $12,000 in mechanical royalties *because she already received substantial advances on the mechanical royalties earned by the song.* Most of the royalties to which she would otherwise have been entitled went to recoup the advances. This was a common tactic used by the Copyright Owners at trial—to make it seem as though a song earned lower mechanical royalties by obscuring the fact that the writer was prepaid substantial mechanical

royalties in the form of an advance. *See also* Bogard WDT at 9-10, CO Trial Ex. 2; Carnes WDT at 5-6, CO Trial Ex. 1.

B. Record Companies

228. Throughout their proposed findings, the Copyright Owners repeatedly tell this Court that the current industry downturn is over and that the future will be nothing but smooth sailing for the record companies. But the evidence contradicts the Copyright Owners at every turn:

- The Copyright Owners contend that the current downturn in the music industry is just like every other cycle of technological change in the past—but the evidence shows that the transition to digital has been far more difficult and continues to carry far more perils than the switch to CDs in the 1980s, or the transition to cassettes before that.
- The Copyright Owners argue that record companies are unable to control their costs—but the evidence shows that they have brought down expenditures in every single category except the one that is set by this Court, namely mechanical royalties.
- The Copyright Owners argue that record company profit margins are on the rise—but the evidence shows that this is false and that profit margins, after a small rise in 2004 and 2005, are now falling once again.
- The Copyright Owners argue that digital distribution of music is cost-free and will improve the record companies' fortunes—but the evidence shows that digital sales are unable to make up the loss in revenues from the decline in physical, and they bring in less revenues and lower profits that anyone in or out of the industry had predicted.

229. In short, despite the Copyright Owners' fallacious claim that "all is well" for the record companies, the truth is that all is decidedly *not* well today, and is not likely to be well for many years in this industry. The evidence of this, to which the Copyright Owners simply turn a blind eye, is overwhelming.

1. Contrary to the Copyright Owners' Assertions, the Current Downturn in the Music Industry Is Fundamentally Different from Prior Industry Cycles.

230. The Copyright Owners' distorted picture of the financial situation of the record companies begins with their description of historic trends in the business. In an apparent effort to show that conditions will soon improve for the record industry, the Copyright Owners note that "[t]he recorded music industry historically has undergone cyclical growth and profitability." CO PFF ¶ 356. The Copyright Owners then discuss the two periods of rapid growth in the industry since 1969, each of which was driven by a new format and new technology. CO PFF ¶¶ 357-361.

231. But the fact that the introduction of new technologies has been a boon in the past only proves RIAA's point, which is that the current period is unlike anything that has happened before. As RIAA demonstrated in its proposed findings, the historic trend was that when an older format was in decline, a newer format was already on the rise and more than made up for the loss of older-format sales. That is what marked the transition from LPs to cassettes, and from cassettes to CDs. *See* RIAA PFF ¶¶ 232-233 & PFF Figure 13.

232. But that is, of course, not what is happening today. As RIAA showed in its proposed findings, thanks to rampant music piracy and the ease with which CD tracks can be "ripped" onto portable music players, the growth in digital sales has not even come close to offsetting the drastic decline in CD sales. RIAA PFF ¶ 234. All of this is taking place at a time of rapidly dropping retail prices—something completely contrary to the historical pattern, as even the Copyright Owners' purported expert admitted. RIAA PFF ¶ 235; 2/6/08 Tr. 1853:21-1854:4 (H. Murphy) ("Q: So certainly, with respect to what we've seen happen in the digital

marketplace so far, the transition to digital has not allowed for higher prices, as in the case with past technological changes, right? A: Correct").

233. Thus, while new formats have usually been a boon to the record industry, that is certainly not the case today and for the foreseeable future. To the contrary, the transition to digital distribution of music, quite unlike prior format transitions, has been devastating to the industry. This is not business as usual, and the Copyright Owners are disingenuous to suggest that it is.

2. The Copyright Owners' False Portrayal of Record Company Expenditures Cannot Hide the Fact That Mechanical Royalties Are the Only Cost That the Record Companies Have Been Unable to Cut.

234. The Copyright Owners suggest that record company costs continue to rise, with the exception of manufacturing and distribution. CO PFF ¶ 421. But they have to contrive a misleading blend of measurements in order to support this assertion—varying between absolute and percentage measures, between overall and unit costs, and between different timeframes. Thus, for overhead the Copyright Owners discuss absolute costs for the period 1999 to 2003 and unit costs for 1999 to 2006; for artist royalties they discuss percentage of net sales revenue for 1991 to 2006; for mechanical royalties they discuss percentage of *total* revenue (not net sales revenue) from 1991 to 2001; for marketing they discuss percentage of net sales revenues for 1991 to 2006; and for advances and recording costs they combine absolute costs from 1991 to 2003 with percentage of total revenue (not net sales revenue) for 1991 to 2006. CO PFF ¶¶ 422-437.

235. But no matter how they try to avoid them, the plain facts are these: as RIAA has already amply demonstrated in its findings, *see* RIAA PFF Section II.E.1.c, since 1999 (the year that record sales peaked before the current industry downturn and when the statutory rate was 7.1

cents) the actual dollars spent by the record companies has fallen in *every* single category except mechanical royalties. Thus, as Figure 1 to Bruce Benson's report showed (reproduced below as RIAA RPFF Figure 2), between 1999 and 2006 artist royalties have fallen from $1,228 million to $1,104 million; advances and recording have fallen from $412 million to $246 million; marketing has fallen from $1,094 million to $824 million; manufacturing has fallen from $713 million to $511 million; distribution has fallen from $816 million to $563 million, and overhead has fallen from $1,289 million to $1,241 million. By contrast, *mechanical royalties climbed from $512 million to $547 million* during the same time period:

RPFF Figure 2

US Majors - Totals from 1999 to 2006

In $US Millions

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

Benson WRT at 8 & Fig. 1, RIAA Trial Ex. 82; PFF Figure 8.

236. The result is that for the major labels, mechanical royalties have taken up a larger and larger share of their net sales revenue—rising from 8.7% of revenue in 1999 to 11.5% of sales revenue (a proportional increase of *32%*) in 2006. Benson WRT at 18 & Figure 5a, RIAA Trial Ex. 82. Even if you calculate this as the Copyright Owners do, as a percentage of overall

(rather than net sales) revenue, the result is the same. As simple calculations based on RIAA RPFF Figure 1 show, mechanical royalties were 7.95% of total revenues in 1999 and 10.25% of total revenues in 2006—a proportionate rise of 29%.[12]

238. Thus, contrary to the contorted financial picture contrived by the Copyright Owners, the record is clear: mechanical royalties are the *only* expense that the record companies have not been able to cut.

3. The Copyright Owners Present a Distorted And Inaccurate View of Record Company Profit Margins.

a. The Record Companies' Restructurings Have Already Absorbed Every Penny of the Record Companies' Paper Profits to Date, and They Are Still Not Finished.

239. The Copyright Owners' discussion of profit margins ignores a critical point made by RIAA in its proposed findings: whatever profits the record companies have managed to eke out in recent years have been entirely wiped out by the massive expenditures the record companies have had to make on corporate restructurings. *See generally* RIAA PFF Section II.E.1.c.1. The Copyright Owners have no answer to this claim.

240. Indeed, Ms. Murphy's own calculations showed that from 2001 to 2005 alone, the major labels spent at least $2.7 billion on restructuring costs—more than the $2.1 billion profits that she calculated the record companies earned during this time period. 2/6/08 Tr. 1879:3-1880:21 (H. Murphy). Moreover, the 2001-2005 restructuring costs are even sufficient to wipe out the major's year 2006 profits as well. As Bruce Benson calculated, the major labels earned a total of $300 million in profits in 2006. Benson WRT at 8 & Figure 1, RIAA Trial Ex. 82.

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[12] As RIAA pointed out in its proposed findings, artist royalties and overhead also increased as a percentage of net sales revenues during the 1999-2006 period, simply because these costs did not decline as fast as revenues did. RIAA PFF ¶ 217. But mechanical royalties are the only category of cost that increased in absolute terms over that time period.

Adding that to the profits calculated by Ms. Murphy for the years 2001-2005, one still does not reach a figure that equals the labels' restructuring expenses for the five-year period she examined.

241. As Ms. Murphy herself admitted, the $2.7 billion in restructuring charges that she calculated are only part of the picture. *See* H. Murphy WDT at 17, CO Trial Ex. 15 (since her initial report of November 2006, "the US majors have continued to announce restructuring charges."); 2/6/08 Tr. 1884:14-17 (H. Murphy) (February 2008 trial testimony agreeing that "the restructuring actually is continuing for some record companies"). In fact, thanks to the continuing bane of piracy and the increasing pressure caused by mounting mechanical royalty rates, the record companies' restructurings are still ongoing. For example, Colin Finkelstein testified that although EMI Music underwent restructurings in 2001, 2003, 2005 and 2007, 2/13/08 Tr. 3128:15-22 (C. Finkelstein), even more restructurings are planned. Mr. Finkelstein explained that the new owner of the EMI Group has announced that EMI plans "another round of cost-cutting" as well as a reduction of 2,000 further employees (1/3 of EMI's recorded music staff) around the world. 2/13/08 Tr. 3130:3-17 (C. Finkelstein). Similarly, Warner Music also engaged in another restructuring as recently as 2007—one that cost it roughly $63 to $65 million and left many people without jobs. 2/6/08 Tr. 1890:11-1892:4 (H. Murphy).

242. Even if you take Ms. Murphy's 2006 figures on their face, rather than Mr. Benson's, they show a profit of [REDACTED] for Universal, [REDACTED] for EMI, [REDACTED] for Warner, and [REDACTED] for Sony BMG. H. Murphy WDT at Ex. 4A, CO Trial Ex. 15. Adding those figures to the $2.1 billion in profit that Ms. Murphy calculated for 2001-2005 yields a total profit for the 2001-2006 period of $2.9 billion—only slightly more than the $2.7 billion in restructuring expenses that the record companies incurred from 2001-2005

alone. And as noted above, even Ms. Murphy admits that record company restructurings continued until well beyond 2005.

243. Finally, it should be noted that the costs of these constant restructurings is not just an economic burden to the record companies; it has a very real human toll as well. Between 2001 and 2005, the major record companies had reduced the headcount in their domestic operations from 13,449 down to 8,479—a nearly 40% cut. RIAA PFF ¶ 202. This reduction in "headcount" means, in simple terms, that people got fired. 2/6/08 Tr. 1860:8-1861:14 (H. Murphy). The Copyright Owners have not hesitated to make this Court aware of the supposed economic suffering of songwriters today—claims that are overstated at best—but they have been silent about the very real economic harm that has been done to 5,000 former employees of the record companies who lost their jobs, their benefits, their sources of income, and their opportunities to have a career in the music industry as a result of the current industry decline.

b. Record Company Profit Margins Are Falling, Not Rising.

244. The Copyright Owners contend that "the record companies have been enjoying record profits in recent years." CO PFF ¶ 438. That argument not only ignores the record company restructuring costs, but also fails to account for the indisputable fact that the apparent upturn in record company profits that record companies experienced in 2004 and 2005 was only a temporary event, since reversed by the continuing decline in revenues.

245. As the data from Bruce Benson shows, steadily declining wholesale revenues over the 1999-2003 period took their toll on record company profits, driving them from 5.9% in 1999 down to 3.4% in 2001 and 4.0% in 2002 before those profits hit negative territory, at -0.4%, in 2003. Benson WRT at 8 & Figure 1, RIAA Trial Ex. 82. In 2004 and 2005, by contrast, the record companies enjoyed a brief respite, experiencing a sustained, albeit mild, period of growth

in their overall revenues (from a disastrous 2003). Because the record companies were at that point midway through a wrenching series of restructurings—one in which they had cut artist rosters to the bone, outsourced much of their manufacturing and distribution, reduced their marketing expenditures, and initiated a series of firings that would eventually cover nearly one half of their workforce—the sudden influx of additional revenue, not surprisingly, resulted in two relatively profitable years in 2004 and 2005. *See* Benson WRT at 8 & Figure 1, RIAA Trial Ex. 82 (showing profits of 7.0% in 2004 and 8.5% in 2005). But in 2006, industry sales turned down once again—and just as quickly, so too did profits. Thus, as total record company revenues fell from $5,850 million to $5,336 million, profit margins fell as well, from 8.5% in 2005 to 5.6% in 2006.

246. The recent trends in record company profits that are shown by Mr. Benson's figures simply reflect a broader economic truth in the record industry. Basic economic principles dictate, and recent history bears out, that in an era of declining revenues the record companies can keep afloat only by continuing to restructure their operations and making further cuts in their expenditures. This is not the kind of environment in which the record companies are likely to earn significant profit margins, and indeed that is why their margins were extremely low—indeed in one year collectively negative—during the most recent years of industry downturn. But this also explains why record company profits on an aggregate basis are likely to *remain* low in the future as well. Revenues continued to decline in 2007 and the first quarter of 2008, and are expected continue to decline for at least several more years. RIAA PFF Section II.E.1.d.vi. Thus, with every continuing decline in revenues, the record companies face little choice but to continue to restructure their operations and cut costs even further. In that kind of environment, the likelihood of sizeable profit margins for the industry is slim to none.

247. The Copyright Owners raise three different objections to Mr. Benson's profit margin calculations, but none is persuasive. The Copyright Owners first cherry-pick several of the financial margin figures from their witness, Helen Murphy, to suggest that profit margins are in fact on the rise. CO PFF ¶¶ 442-446. Second, they criticize Mr. Benson for adding additional manufacturing and distribution expenses to the calculation of Ms. McLaughlin, thus reducing the profits of the record companies. CO PFF ¶¶ 449-553. Third, they criticize him for not taking into account the financial results of the majors' distribution companies. CO ¶ 454.

248. It is easiest to take these criticisms in reverse order, as the answer to the third largely addresses the first two as well. The Copyright Owners' contention on this score revolves essentially around the profit and loss statements of one major record company, Universal Music Group. Relying on CO Trial Exhibit 264, a P&L which shows separately the profits of Universal's label and distribution operations for the years 2004-2006, the Copyright Owners argue that instead of using the label profit figures shown on this document, Mr. Benson should have used the *overall* profit figures shown for the label and distribution operations together. CO PFF ¶ 454. But this runs counter to logic and economic theory. As Linda McLaughlin explained, the manufacturing and distribution arms of the record companies are independent operations that manufacture and distribute CDs, videos, and other products not only on behalf of their own label, but on behalf of *other* labels as well. 2/13/08 Tr. 3062:22-3063:10 (McLaughlin). It would make no more sense to count these profits than it would to count the profits of Universal's *publishing* arm, UMPG. In either case, the profits that Universal earns from these activities have nothing to do with the business of Universal labels, which is the recording, marketing, and distributing of Universal sound recordings and which should be the proper focus here. 2/13/08 Tr. 3096:2-4 (McLaughlin).

249. This analysis of the Universal figures also fully answers the Copyright Owners' second objection, which centers around their selective use of data from Helen Murphy's report, *see* CO PFF ¶¶ 442-446. Setting aside Universal for the moment, the figures presented by Helen Murphy are fully consistent with the profit margin trend shown above. As the Copyright Owners acknowledge, Ms. Murphy's figures show that EMI Music's profit margin has been in a consistent decline since 2003, falling from [ ] in that year to [ ] in 2005 and then to [ ] in 2006. CO PFF ¶ 446. A similar trend is apparent for Sony BMG. Although the Copyright Owners note that Sony BMG's pretax profits rose from [ ] in 2004 to [ ] in 2006, CO PFF ¶ 445, they fail to point out that Ms Murphy's figures showed a profit margin of [ ] for Sony BMG in 2005. H. Murphy WDT at Ex. 4A, CO Trial Ex. 15. Thus, even according to Ms. Murphy's calculations, Sony BMG's profit margins slipped, too, in 2006.[13] And while Warner's profit margin did grow from [ ] in 2003 to [ ] in 2006, as the Copyright Owners contend, CO PFF ¶ 442, they fail to mention that nearly all of that growth was between 2003 and 2005. In fact, although Warner's profit margin grew to [ ] in 2004 and then jumped again to [ ] in 2005, Ms. Murphy's figures show a distinct flattening of growth in 2006—again, consistent with the trend lines shown by Mr. Benson. H. Murphy WDT at Ex. 4A, CO Trial Ex. 15.

250. That leaves Universal, the largest of the record companies. According to Ms. Murphy, Universal's profit margin grew from [ ] in 2004 ([ ] profits against [ ] revenues), to [ ] in 2005 ([ ] profits against [

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[13] The Copyright Owners rely on a document *that they did not move into evidence*, CO Trial Ex. 213, to substantiate their contention that Sony BMG earnings increased in 2007. CO PFF ¶ 445. The Court should thus disregard this assertion altogether. In any event, even if the assertion is credited, nothing in CO Trial Ex. 213 purports to show Sony BMG domestic profit margin from record company operations in 2007, rendering it irrelevant to this discussion.

] revenues), to [ ] in 2006 ([ ] profits versus [ ] revenues). CO PFF ¶ 444. As it happens, these figures are close to the figures that the Copyright Owners contended that Bruce Benson should have used for Universal—the figures that, as noted above, include the revenues and profits of Universal's distribution company. *Compare* CO Trial Ex. 264 (showing [ ] profits and [ ] revenues in 2004, [ ] profits and [ ] in 2005, and [ ] profits and [ ] revenues in 2006). But as the above discussion shows, it would be unreasonable to take into account the revenues and profits of Universal's distribution activities, as those activities involve sound recordings that Universal did not record (and therefore did not incur marketing, A&R, and other expenses but also did not receive revenue from sales, other than a distribution fee) and revenues that will not accrue to the benefit of Universal's artists. Thus, contrary to the Copyright Owners' argument, CO Trial Ex. 264 does not show that Mr. Benson was wrong—to the contrary, it shows the extent to which Ms. Murphy erred in her presentation of record company financials.

251. The above analysis also largely answers the Copyright Owners' remaining objection. The Copyright Owners contend that Mr. Benson added some $1 billion in manufacturing and distribution costs to Universal's expenses for 1999-2005, thus reducing Universal's profitability during this period. CO PFF ¶¶ 451-452. But this is just the flip side of the argument about Universal's distribution center profits. Excluding those profits naturally requires calculation of a price that the distribution company will assess the label for distributing the label's sound recordings. As Mr. Benson explained, Universal revised its calculation of that price between the testimony of Ms. McLaughlin and Mr. Benson, and Mr. Benson's testimony therefore reflected that revised price. 5/8/08 Tr. 5536:18-5539:9 (Benson). The Copyright

Owners quibble with the revised price that was set, but they offer no evidence whatsoever that the revised price was wrong or, for that matter, what it should have been. Nor do they have any basis for suggesting that Mr. Benson's use of this revised price altered his bottom line conclusion, namely that the profit margins of the record companies fell between 2005 and 2006.

4. Despite the Copyright Owners' Claims to the Contrary, Digital Distribution of Music Will Not Improve the Financial Picture for the Record Companies Any Time in the Near Future.

a. Digital Revenues Are Not Projected to Make Up for the Decline in Physical Sales Any Time Soon.

252. The Copyright Owners litter their proposed findings with references to the growth of digital revenues, *see, e.g.,* CO PFF Section VII.B, Section XI, but they stubbornly refuse to acknowledge the obvious: digital revenues have not come close to making up for the loss in physical revenues, and are not about to do so anytime soon. As the evidence assembled by Dr. Teece showed, despite growing digital revenues, overall wholesale revenues for the record industry plummeted in 2006, and the downward trend continued in 2007 and through the first quarter of 2008. RIAA PFF Section II.E.1.b.i.; 2/6/08 Tr. 1902:7-13 (H. Murphy) (total domestic sales were down for 2007, including both physical and digital).

253. Moreover, as RIAA showed, future projections are no better. Projections compiled by Dr. Teece showed that, notwithstanding growing future revenues from digital, overall industry revenues were expected to remain below even the depressed 2002 levels and far below the levels of pre-piracy spending in the late 1990s. Whereas total music spending at retail list approached $18 billion in 1998, the average of the three projections shows spending of $11.6 billion in 2006, $11.3 billion in 2008 and $10.9 billion in 2012. Teece WDT at 54, RIAA Trial Ex. 64. Indeed, the results for 2006 and 2007 showed that even those projections were optimistic. RIAA Trial Ex. 66; 2/19/08 Tr. 3809:15-3811:21 (Teece).

254. The Copyright Owners proffer nothing that remotely refutes these projections. Their discredited economic witness, Helen Murphy, put into the record a Warner Music Group forecast which, according to the Copyright Owners' proposed findings, projects a [ ] compound annual growth rate "for the next five years." CO PFF ¶ 477. But the Copyright Owners inexplicably fail to tell the Court that this document was prepared in the year *2006*, and that more than half of "the next five years" covered by that document, 2006-2010, are in the past. H. Murphy WDT at Ex. 8A at RIAA_00039185, CO Trial Ex. 15. What's more, this document is not only outdated, but *it has already been proven wrong*. The document projects a year-over-year growth in total revenue (including physical and digital) of [ ] between 2005 and 2006. But that is not remotely what happened. In 2005, Warner's net sales revenues, as calculated by Bruce Benson, were [ ], Benson WRT at 35, RIAA Trial Ex. 82, and its net licensing revenues were [ ], CO Trial Ex. 41 at RIAA_008430 (McLaughlin), for a total of [ ]. In 2006, calculated on the same basis by Mr. Benson, Warner's total domestic sales and licensing revenues had fallen to [ ]. Benson WRT at 42, RIAA Trial Ex. 82. That is a far cry from the [ ] *growth* projected by the Copyright Owners' document.

255. Nor can the record companies count on additional revenues from so-called "360 deals," as the Copyright Owners claim, to make up for the loss in revenues from physical sales. Such agreements are a new phenomenon and have no impact on the financial data in the record. To be sure, record companies do indeed make efforts to generate additional sources of revenue outside of traditional sales of CDs and digital downloads. But these efforts are in their infancy, and nobody knows whether they will yield significant forms of revenues for the labels. The Copyright Owners did not present *any* testimony as the amount of revenues the record companies

generate, or can expect to generate, from these deals during the period covered by this proceeding. Moreover, as Terri Santisi explained at trial, it is not as if record companies come across these additional lines of revenue for free. To the contrary, to the extent that the record companies can persuade artists to sign 360 deals, the record companies generally have to compensate the artists with larger advances and make additional investments in other lines of business (such as t-shirt or concert promotion companies). In effect, the record companies must *buy* the additional revenue streams, which raises the level of investment by the record company and thus the risk that the investment will not be repaid. Santisi WRT at 17 n.30, RIAA Trial Ex. 78. Thus, these additional revenue streams have little or no relevance here.

b. Digital Distribution Has Required Significant Upfront Capital Expenditures.

256. The Copyright Owners argue that the record companies have made little investments in digital infrastructure, CO PFF Section XV.D.2, but that is contradicted by the evidence. In fact, as RIAA showed, the evidence shows that the record companies have made massive investments in digital infrastructure. RIAA PFF Section II.E.1.e.iv.

257. The Copyright Owners argue that RIAA has failed to quantify this evidence, but they mischaracterize the record to do so. For example, they assert that Colin Finkelstein of EMI Music "provided numbers that were worldwide rather than for the U.S." CO PFF ¶ 751. That is not correct: As Mr. Finkelstein made clear, he presented figures for *both* direct U.S. digital expenditures and worldwide digital expenditures (which support U.S. and foreign operations). In fact, Mr. Finkelstein's testimony says: "From 2002 through 2006, EMI Music's global IT group has invested approximately [ ] in capital expenditures. *This includes roughly* [ ] *in information technology expenditures for U.S. operations alone.*" C. Finkelstein WDT at 20, RIAA Trial Ex. 57 (emphasis added); *see also* RIAA PFF ¶ 340.

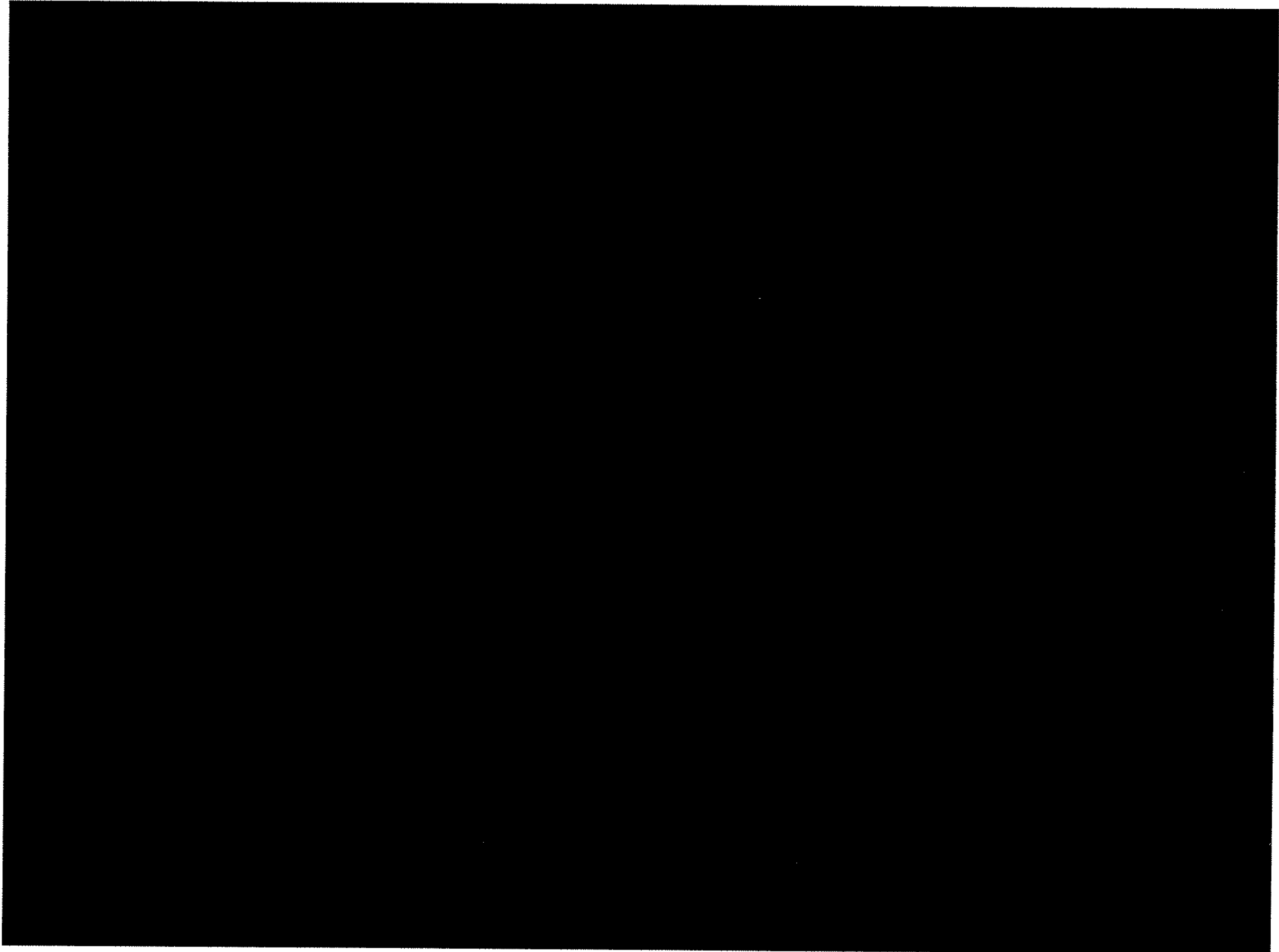
258. As for the specific amount that the record companies spent on digital IT capital expenditures, the Copyright Owners attempt, through Helen Murphy, to show that the transition to digital has required "minimal cost." CO PFF ¶ 752; H. Murphy WDT at 24-25, CO Trial Ex. 15. But the figures Ms. Murphy presented should be discounted for a number of reasons. First, it is unclear whether Ms. Murphy was examining capital as opposed to marginal expenditures. Although she discussed certain of the figures in EMI Music's "capital expenditure detail," she also characterized all of the expenditures that she analyzed in this section as the "record companies' *incremental* costs of digital distribution." H. Murphy WDT at 24, CO Trial Ex. 15 (emphasis added). Incremental costs are, of course, *marginal* costs, which would naturally be considerably lower than capital expenditures. Ms. Murphy appears to have confused the two.

259. Second, Ms. Murphy's numbers should be discounted because she herself admitted that she did not have "adequate information regarding incremental costs of digital distribution" for *any* record company. H. Murphy WDT at 24 n.66, CO Trial Ex. 15. Of course, the fact that she did not have adequate information did not stop Ms. Murphy from presenting testimony about the expenditures of the record companies in the area of digital distribution. But this Court need not, and should not, give that testimony any weight.

260. Third, in the case of EMI, Ms. Murphy's confessedly "[in]adequate information" conflicts with the information presented to this Court by the one person who would know best—EMI Music North America's CFO, Colin Finkelstein. According to Ms. Murphy, EMI's capital IT spending is expected to be only [ ] over the 2002 to 2011 period. CO PFF ¶ 752; H. Murphy WDT at 24, CO Trial Ex. 15. But Mr. Finkelstein's testimony makes clear that, in fact, EMI Music spent roughly [ ] in direct U.S. information technology expenditures

between 2002 and 2006 alone, and expects to spend another [ ] by 2011 for a total of [ ] between 2002 and 2011, as the following chart illustrates:

RPFF Figure 3 - RESTRICTED



C. Finkelstein WDT at 20 & Figure 10, RIAA Trial Ex. 57; RIAA PFF at PFF Figure 27.

261. Notably, the Copyright Owners did not attempt to impeach Mr. Finkelstein's figures for U.S. IT expenditures during cross examination. In fact, the cross examination of Mr. Finkelstein made clear that, if anything, these numbers are conservative. As Mr. Finkelstein explained, the [ ] in 2002-2006 expenditures is only for those expenditures that were made *directly* in the United States. 2/13/08 Tr. 3202:7-12 (C. Finkelstein). But much of EMI's

digital supply chain is managed outside the United States, and thus many of EMI's overseas expenditures go to support U.S. distribution activities:

> Q. So, in fact, this huge expenditure in the U.S. digital supply chain is [ ]?
>
> A. No, that's not true. The [ ] is the amount that was directly spent in the U.S. We have a structure within EMI that has a global organization that builds global supply chains. So as an example, the tool that we use to take digital product to the marketplace is managed globally.
>
> . . . The [ ] that we're referring to here is the direct element. There are certain costs that are in the digital space that are managed domestically. The [ ] is the piece that our IT guy in North America managed as part of that bigger global budget.

2/13/08 Tr. 3202:7-22 (C. Finkelstein).

c. Digital Distribution Has Required Far Greater Ongoing Expenses Than Originally Anticipated.

262. The Copyright Owners expend a great deal of effort attempting to prove that digital distribution is cost-free. CO PFF Section IX.B.2. But the evidence at trial showed otherwise.

263. As RIAA explained in its proposed findings, the record companies' experience with digital distribution has shattered the belief, once held by many in the record industry, that digital distribution of music would not carry any costs. *See generally* RIAA PFF Section II.E.1.e.iv. As RIAA explained, even as recently as the year 2005, many record company executives believed that digital distribution of music could save on most distribution costs. RIAA PFF ¶ 329. But since then, the record companies have learned that distributing musically digitally is not as simple and inexpensive as once hoped. For one thing, record companies have had to distribute far more different products in the digital age in order to meet varying retailer and consumer demand—as many as 100 products from one single piece of music alone. RIAA PFF ¶ 333; 2/26/08 Tr. 4730:17-20 (Munns). For another, record companies must transmit their

products in a multitude of different formats, due to different technical requirements and the lack of interoperability among various music delivery devices. RIAA PFF ¶ 334; Munns WDT at 6, RIAA Trial Ex. 76. Finally, the record companies must deal with many different digital distributors, each with a different business model and different requirements. RIAA PFF 336; Munns WDT at 6, RIAA Trial Ex. 76. Thus, the optimism many held in the industry back in 2005 no longer holds sway.

264. The evidence presented by RIAA shows that digital distribution tends to be roughly around 10 percent of net sales revenues. For example, documents created in the ordinary course of business by UMG put digital distribution costs at [ ] of digital revenues. Benson WRT at 9, RIAA Trial Ex. 82. Similarly, EMI Music's business documents put digital distribution costs at [ ] of revenues. CO Trial Ex. 47 at RIAA 0045905. And this was backed up by ample testimony at trial. *See, e.g.*, 2/14/08 Tr. 3237:18-3238:5, 3263:5-8 (C. Finkelstein) (testifying that EMI Music's digital revenues have turned out to be higher than expected over time). Independent label witnesses testify that they pay the same amount for digital distribution as they do for physical distribution. *See, e.g.*, Barros WDT at 10, RIAA Trial Ex. 74 (Concord's distributor charges it the same distribution fee for digital as for physical). *See generally* RIAA PFF ¶¶ 342-344.

265. Ignoring this evidence, the Copyright Owners pluck out of the record a handful of documents that purport to show that digital distribution is free. But the Copyright Owners' evidence falls short of the mark.

266. The Copyright Owners place great reliance on an EMI Music digital profit and loss statement which purports to show distribution costs of [ ] for the year-to-date September 2007. CO PFF ¶ 429. Even on its face, of course, the Copyright Owners should

recognize that this is implausible—digital distribution might be less expensive than physical distribution, but nobody thinks one can earn money simply by using the Internet. In any event, Colin Finkelstein, EMI Music's CFO for North America, very clearly explained that this was *not* a document created in the ordinary course of EMI Music's business. 2/14/08 Tr. 3267:7-10 (C. Finkelstein). To the contrary, he explained, this was an experimental document—one of five different iterations of the same type of document, 2/14/08 Tr. 3267:11 (C. Finkelstein)—that was created pursuant to the express instructions of EMI Music headquarters in London about how to characterize certain expenses. 2/14/08 Tr. 3266:14-20 (C. Finkelstein). And those express instructions, Mr. Finkelstein explained, were to spread the costs of digital distribution throughout numerous lines of the document, including overhead, rather than to place them on the "distribution" line. 2/14/08 Tr. 3266:7-17 (C. Finkelstein).

267. More importantly, the digital distribution figure in this digital P&L is contradicted by a much more reliable EMI Music business document—one that the Copyright Owners *themselves* put into the record. CO Trial Exhibit 47 is a ringtone agreement between EMI Music and Ericsson, Inc. Affixed to the back is a six-page document known as a Capital and Special Authorisation Form which contains a detailed financial analysis of the agreement. It is thus a document as to which EMI would have had a high degree of interest in ensuring accuracy, because its most senior executives relied on it in the course of their day to day business. And what that document shows, as discussed above, is that EMI's "digital distribution cost" is listed at [ ] of EMI's revenue. CO Trial Exhibit 47 at RIAA_0045905.

268. Even if the Court had nothing more to go on than these two EMI business documents—the regularly created EMI Music North America business document that shows digital distribution at [ ], or the experimental document created pursuant to instructions

from London that implausibly shows that the cost of digital distribution is negative, RIAA submits that there should be no difficulty in deciding to credit the former. But in this case, as well, the Court has the benefit of testimony by the person who would be in the best position to know – EMI Music's North American CFO, Colin Finkelstein—that digital distribution is costly.

269. The Copyright Owners' second tack is to point to the optimistic statements in documents dating back to the year 2005. CO PFF ¶¶ 430-432. But these also do not support the Copyright Owners' case. The first cited passage is from EMI's Annual Report for 2005. As an aside, the cited passage says only that manufacturing, returns, and "pick-pack-ship" costs do not exist in the digital world—it certainly does not say that there are no distribution costs for digital. Thus, it does not support the Copyright Owners' position. But more importantly, as Colin Finkelstein explained, this 2005 annual report is simply out of date. Since 2005, as Mr. Finkelstein explained, the record companies' initial optimism about digital distribution has largely been shattered. *See* RIAA PFF ¶ 329; 2/13/08 Tr. 3172:15-3173:5, 3175:17-21 (C. Finkelstein). As a result, EMI's annual report for 2007, just two years later, took a decidedly less optimistic view. RIAA Trial Ex. 7 at 28; RIAA PFF ¶ 330.

270. The same can be said for the Warner annual report and the Sony digital P&L touted by the Copyright Owners. *See* CO PFF ¶¶ 431, 432. Both of these documents date to the year 2005—an era when the record companies had a much more optimistic view of digital distribution than they do today.

271. Finally, the Copyright Owners seize on a statement in a white paper produced by Mr. Benson in 2007, well before he took on his present assignment for RIAA. As Mr. Benson candidly acknowledged at trial, it was indeed his belief, at the time the white paper was created, that digital distribution carried no costs. But as Mr. Benson explained, two things have happened

since that time to alter his view. One, of course, is that he was exposed to the testimony of Colin Finkelstein and the internal business documents of EMI and Universal—all of which, as noted above, credibly pointed to a digital distribution cost of around 10 percent of revenue. Benson WRT at 9, RIAA Trial Ex. 82.

272. The other thing that changed Mr. Benson's opinion about the costs of digital distribution is that after writing his white paper, in the summer of 2007, Mr. Benson was engaged to audit digital retailers of music such as Rhapsody and the phone companies. 5/8/08 Tr. 5610:17-5611:7 (Benson). And what he found was strikingly similar to the lessons that the record companies themselves have learned from their experience in digital distribution—that the varying number of services and digital formats at the present creates considerable logistical challenges. As a result, he came to learn, even before being engaged by RIAA for the present task, that digital distribution costs are "clearly not zero":

> Q. Since the time that you wrote your white paper, did you come to have some personal experience with digital distribution costs in the record companies?
>
> A. Yes. So we have a practice that we established around the summer of 2007 to do what we call digital revenue audits. And these are audits of the digital retailers, such as Rhapsody or the phone companies, to make sure that the record companies are getting paid fairly under their digital contracts. For example, we audited four or five years of Rhapsody.
>
> And what we have come to find out firsthand -- that not only is there a lot of staff employed at the labels to manage digital distribution, but the number of people is, in fact, growing. And that's because it turns out that digital contracts are quite complex. They are all done on different bases. Some of them are ad-based -- ad revenue-based. Some of them are unit sales-based, some are subscription-based. The data that they get back from these retailers is inconsistent. The checks all need to be reconciled.
>
> So digital is not scaling very well at the moment inside the majors.
>
> Q. And based on that experience that you got after writing your white paper, are you able to say whether or not digital distribution costs are zero?
>
> A. Digital distribution costs are clearly not zero.

5/8/08 Tr. 5610:17-5612:5 (Benson)

273. Thus, Mr. Benson's experience is precisely similar to that of the record company witnesses themselves: what appeared even as recently as a few short years ago to be a low-cost method for distributing music has turned out, in practice, to be anything but.

d. Due to Its Substantial Costs and Relatively Low Revenues, Digital Is Not Likely to Significantly Increase Record Company Profit Margins.

274. As RIAA's proposed findings showed, the significant costs of digital distribution, coupled with the lower revenues yielded by digital sales, has ensured that digital distribution is far less of a boon to record company profitability than portrayed by the Copyright Owners. As Bruce Benson's report made clear, on a unit basis digital sales are only marginally more profitable than physical sales, and those sales bring in only pennies of profit per digital track. Benson WRT at 4-6, RIAA Trial Ex. 82. Indeed, one of the fastest-growing digital formats, digital album downloads, is *unprofitable* on a unit basis at today's prices, portending a rocky road ahead for record company margins. Benson WRT at 5, RIAA Trial Ex. 82; *see also generally* RIAA PFF Section II.E.1.e.iii.[14]

275. Contrary to this evidence, the Copyright Owners persist in arguing that digital transmission of music will result in higher profitability for the record companies in the future.

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[14] Of course, just because the sale of digital albums is unprofitable on a per-unit basis does not mean there is no business reason to sell those albums. The wholesale revenue brought in by each digital album sold, which is $6.88, still exceeds the incremental per-unit cost of artist royalties ($1.57), mechanical royalties ($1.18), and distribution ($1.02). *See* Benson WRT at 25 & Figure 9, RIAA Trial Ex. 82. Thus, digital albums still are profitable on a *marginal* basis even if they are not profitable when other costs, such as marketing and advances & recording and overhead are factored in. However, those other costs are relatively fixed for any given release, meaning that even if the record companies released their products only in CDs and digital singles and mobile formats, they still would have to spend the same amount on these categories of expenses. Thus, it makes business sense for the record companies to try to get as much marginal revenue as they can for these products, even if it means selling them in formats that are unprofitable on a fully-allocated basis.

CO PFF Sections IX.C, XI (forecasts). To buttress their case, the Copyright Owners level three critiques of the work of Mr. Benson, none of which comes close to the mark.

276. The Copyright Owners first argue that Mr. Benson's analysis of digital profits is flawed because he used an inaccurate number for the cost of digital distribution. But as explained above, Mr. Benson's digital distribution figure was amply supported by the business records of the record companies. *See* RIAA RPFF Section IV.B.4.

277. The Copyright Owners' second critique is that Mr. Benson's analysis of profitability projections for 2007-2011 takes into account only the profits from CDs and digital downloads (albums and singles) while excluding profits from mobile digital sales—that is, ringtones and mobile downloads. That is correct, and Mr. Benson's analysis has never suggested otherwise. What that analysis shows, as Mr. Benson's testimony makes clear on its face, is that the combined profitability from CD sales and from downloads of digital album and digital singles will steadily decline from 2007 through 2011. Benson WRT at 30 & Figure 12, RIAA Trial Ex. 82. And there was a very good reason that this forecast did not include mobile downloads: as Mr. Benson explained at trial, projections of mobile sales of albums versus sales of singles simply do not exist. 5/8/08 Tr. 5602:21-5603:11 (Benson). Certainly the Copyright Owners did not present any such analysis to the Court, notwithstanding their criticism of Mr. Benson for not having done so.

278. The Copyright Owners' third critique of Mr. Benson's work is that he added some $1 billion of additional distribution and manufacturing expenses to the numbers previously calculated by Ms. McLaughlin for the 1999-2005 period. CO PFF ¶¶ 449-452. But this criticism works against the Copyright Owners. As Mr. Benson explained, because his model uses a fixed rate of 10 percent of revenue for digitally distributed products, the additional expenses that he

added to Ms. McLaughlin's numbers for distribution and manufacturing actually had the effect of making only *physical* products appear less profitable, while leaving the profitability of digital products at the same level. 5/8/08 Tr. 5545:7-22 (Benson). Thus, removing these additional expenses and restoring the numbers used by Ms. McLaughlin would simply *narrow* the gap between digital and physical—precisely the opposite of the point the Copyright Owners are trying to make. 5/8/08 Tr. 5545:19-22 (Benson).

279. Finally, the Copyright Owners also point to a handful of record company documents in the record that, they claim, advance their argument that digital distribution will boost the record companies' profits in future years. Yet as their own findings admit, the documents on which they principally rely are merely projections for the profitability of the record companies' *worldwide* businesses, not their domestic U.S. operations. CO PFF ¶¶ 474 (EMI), 476 (Sony). As the Copyright Owners' own cross examination of RIAA witnesses showed, the worldwide performance of the record companies does not necessarily reflect their performance here in the United States. *See* 2/13/08 Tr. 3158:3-6 (C. Finkelstein) (agreeing with counsel's statement that "EMI U.S. has underperformed relative to the rest of the recorded music company in other territories").

280. There are additional reasons why the EMI document, in particular, should not be given weight by this Court. The document which the Copyright Owners describe as a "projection[]", CO PFF ¶ 474, is in fact an investor document that was prepared by the Terra Firma investment group subsequent to its acquisition of EMI Group *without reference to internal company financials*. The document contains a full-page "disclaimer" which states: "[Terra Firma] acquired the Company by way of a public to private transaction. Consequently, access to information regarding the Company was restricted. As a result, this document, to the extent that

it relates to the business of the Company, is based on historical information largely taken from public sources which has not been independently verified." RIAA Trial Ex. 9 at CO04032284. Indeed, Colin Finkelstein, EMI's North American CFO, testified that he had never seen the document prior to trial, nor had he seen the underlying model or the assumptions on which it was based. 2/13/08 Tr. 3164:12-3165:15 (C. Finkelstein).

281. The Copyright Owners also cite a series of Warner Music documents which purport to show much higher margins on digital products than on physical products for various Warner labels. CO PFF ¶ 442. But as the Copyright Owners' economic witness Helen Murphy admitted, during the years she was at Warner the company did not make any effort to allocate overhead to its digital profit and loss statements. 2/6/08 Tr. 1946:12-18 (H. Murphy). Thus, they are not true measures of the relative profitability of digital versus physical products.

282. Finally, the Copyright Owners engage in a series of distortions of the record in order to persuade this Court that RIAA's witnesses said one thing about record company profitability when in fact the record shows that they said something completely different. For example, the Copyright Owners contend that EMI's Colin Finkelstein "testified that the current chairman of the EMI Group, Guy Hands, has projected enormous growth in the profitability of EMI." CO PFF ¶ 475. But this was just a reference to the very same Terra Firma document—RIAA Trial Ex. 9—that the Copyright Owners referenced earlier. As noted above, Mr. Finkelstein clearly testified that he had no personal knowledge of the document, that he had not even seen it prior to trial, and that it was a document that related to the worldwide activities of EMI rather than the North American activities for which he is responsible. 2/13/08 Tr. 3163:20-3165:15 (C. Finkelstein). At trial, when asked about it, Mr. Finkelstein could only read what the document itself said, rather than testify as to personal knowledge. 2/13/08 Tr. 3164:12-21 ("Q.

Have you seen the Terra Firma forecasts that he has put together? A. I saw it briefly in our attorney's office on Friday. I had not seen it prior to that. Q. But you would agree with me that what Mr. Hands is projecting is an enormous growth in profitability of EMI worldwide, correct? A. *From that chart that I saw, yes*.") (emphasis added). The Copyright Owners' reason for doing this is clear: knowing that the Terra Firma projections are entitled to little weight in this Court, they hope to bolster it by putting its conclusions into the mouth of Mr. Finkelstein. But the record just does not support that assertion.

283. Similarly, the Copyright Owners contend that Colin Finkelstein "agreed that it was EMI's view that, because digital margins are higher than physical margins, the company's profitability would grow as the digital business grows." CO PFF ¶ 475. In fact, what Mr. Finkelstein actually was asked at trial was whether EMI has had that view "for some number of years." 2/13/08 Tr. 3165:17 (C. Finkelstein). Mr. Finkelstein said that it had, but he also explained, as noted above, that *in recent times EMI's view has changed.* In fact, as RIAA noted in its opening findings, the current official view of EMI—as reflected in its 2007 annual report—is that "[l]egitimate digital product and service offerings are still in the early stages of development and their ultimate impact on our business cannot be predicted with certainty," and that "[t]hese new business models *may not develop in a way which generates significant profits for our business or they may result in lower or less profitable sales for us than comparable physical sales*." RIAA PFF ¶ 330; 2/13/08 Tr. 3288:12-3289:15 (C. Finkelstein) (emphasis added).

284. The Copyright Owners' distortions of the record do not end with EMI. They also contend that Michael Kushner of Atlantic Records testified "that he believes today that the record industry will emerge from its current transition period as a healthy industry, in part due to

the great opportunities in the digital side of the business." CO PFF ¶ 443. But they do not actually quote Mr. Kushner on this point, and there is a very good reason: *Mr. Kushner said no such thing.* Mr. Kushner did indeed testify that he believes that the record industry will eventually emerge from this transition as a healthy industry. 2/14/08 Tr. 3487:4-13 (Kushner). But Mr. Kushner did not say *when* he believes this will happen, and, critically, he did *not* say that this would be because of the greater opportunities in digital. In fact, what he very specifically said—in the very passage that the Copyright Owners cite—is that while there are opportunities in the digital world, "the question is whether the growing opportunities of the digital business would make up for the losses we were suffering in the areas of the physical business and as a result of piracy":

> Q. You were not confident in the fall of 2006 that the digital era would ultimately be one of growing opportunities for the music business, is that your testimony?
>
> A. I think that it would be an area of opportunities, but the question is whether the growing opportunities of the digital business would make up for the losses we were suffering in the areas of the physical business and as a result of piracy.
>
> There's no question that there's great opportunities in the digital world. You know, you just have to look at the ubiquity of music to see that, if it can be monetized properly, money can be made and the business can survive. But how the business will survive and what -- what state it will survive and how many companies will survive in the long run, *that's something that I wasn't necessarily so confident about.*

2/14/08 Tr. 3482:2-20 (Kushner) (emphasis added).

5. The Copyright Owners' Claim That Record Companies Were Slow to Enter the Digital Marketplace Is Demonstrably False.

285. Citing their witnesses Ms. Murphy and Ms. Enders, the Copyright Owners claim that the recorded music industry was slow to "embrace digital distribution," did not launch their own legitimate music services until "two years too late" in 2001, and did not do enough to

"prepare for the shift" to digital, all of which they say helped file-sharing sites such as Napster take hold. CO PFF ¶¶ 23-24, 362-364.

286. Initially, the Copyright Owners' argument is simply irrelevant to this proceeding. Whether the record companies started digital distribution of their recordings in 1999, 2001 or 2003 should not have an impact on what the mechanical royalty rate should be for the period 2008 through 2012. By the Copyright Owners' logic, if digital distribution had taken off earlier, that would somehow mean that the rate should now go *down* as a result. But that is equally illogical—and it is surely not the Copyright Owners' position.

287. Irrespective of their relevance, however, the Copyright Owners' claims are contrary to the evidence. The Copyright Owners' Monday morning quarterbacking cannot obscure the fact that unlike music publishers and songwriters, record companies have invested hundreds of millions of dollars in creating the infrastructure for the digital marketplace and developing the systems that are necessary for the digital distribution of music. *See* RIAA PFF ¶¶ 1351-1365. Nor were these efforts delayed—the evidence shows that record companies began developing strategies for the digital distribution of music in 1996 and began working on the digital infrastructure in 1998; that deals were being done with download services by 1999; and that recordings were available for sale online by 2000. *See* RIAA PFF ¶¶ 1359, 1365; Hughes WDT at 1, RIAA Trial Ex. 73.

288. Moreover, it was through efforts spear-headed by RIAA and the record companies that Napster in particular was shut down in 2001. *See* RIAA PFF ¶ 1393. It is disingenuous, to say the least, for the Copyright Owners to suggest that the record companies did not do enough to combat piracy—the evidence makes it crystal clear that record companies have led the fight

against piracy and spent hundreds of millions of dollars doing so, while publishers and songwriters have done next to nothing. *See* RIAA PFF ¶¶ 1391-1414.

289. The Copyright Owners also suggest that the record companies somehow contributed to the onslaught of online music piracy by purportedly refusing to put copy protection on CDs. CO PFF ¶ 362. But this claim has no merit. In fact, when CDs were originally released, in the early 1980's, the technology simply did not exist to copy-protect CDs . 2/20/08 Tr. 4013:10-16 (Wilcox). For roughly the first 15 years, from the introduction of the CD until the late 1990s, the CD was a reasonably secure product. It was only technological developments in the late 1990s that made CD ripping possible. Bassetti WDT at 6-7, RIAA Trial Ex. 68.

290. Moreover, as the evidence at trial showed, once CD copying became possible, copy protection would have been counter-productive because consumers demand portability in their music, which means the ability to copy their CDs to their computer or to a portable player. The Copyright Owners' expert, Claire Enders, testified that [█] of iTunes users cited the ability to put their music on a portable device as a reason for buying music online. Enders WDT at 21, CO Trial Ex. 10. *See also* 5/7/08 Tr. 5247:17-19 (Santisi) ("[T]he consumer is saying, I need to be able to get this from my one device to another device."). It is hard to understand how the Copyright Owners can criticize the record companies for doing something that would have hurt CD sales, to the detriment of record companies, music publishers and songwriters alike.

291. Ironically, when one record company thought it found a way to bridge this gap between consumer demands and the need for copy protection, it was the publishers who stepped in the way. For several years Sony Music evaluated technologies that might make the CD format more secure, while also allowing consumers some ability to use the music on the disc on a

computer. Wilcox WDT at 26, RIAA Trial Ex. 70. By 2003-2004, Sony thought it had found an appropriate technology. However, because that technology involved including both regular audio tracks and a second set of DRM-protected tracks in a format for use on a computer, publishers asserted that they had the right to be paid twice for that right. Wilcox WDT at 26, RIAA Trial Ex. 70. The Copyright Owners can hardly complain about the lack of copy protection on CDs when it was their own intransigence that hindered this development.

6. A Cut in the Mechanical Royalty Rate Would Benefit Music Publishers, Songwriters, and Music Consumers Alike, While an Increase in the Rate Would Hurt Everybody.

292. The Copyright Owners contend that "there is no evidence to suggest that a reduction in the mechanical royalty rate would lead to increased A&R spending, nor does the record support the claim that an increase in the mechanical rate would lead to a reduction in such spending." CO PFF ¶ 756. This statement is utterly false.

293. First, Glen Barros of Concord Record emphatically testified that it would. As he said: "I can speak personally – and I think this applies to the industry, but personally, we reinvest every dollar of operating profit that we make back into new recordings, and those new recordings, of course, generate revenue." 2/21/08 Tr. 4132:13-18 (Barros). Thus, Mr. Barros testified: "I can say personally with certainty that . . . with a lower rate, we would invest more money in new recordings because our overall strategy is to build long-term asset value, so we're trying to record and promote as much as possible." 2/21/08 Tr. 4133:4-10 (Barros). The Copyright Owners simply ignore this testimony.

294. Indeed, all of the record companies to offer testimony in this proceeding, major and independent alike, have underscored the importance of A&R spending on the overall health

of their company—and the record industry as a whole. As David Munns of EMI explained, spending on artist development is, quite simply, "what record companies . . . exist for":

> What record companies like EMI exist for is to provide as much array in choice as they can of musical diet for the public. That's really what they do. And the artist roster is really like the R&D department of a record label.

2/26/08 Tr. 4737:12-17 (Munns).

295. Michael Kushner of Warner Music similarly explained that that cutting artist rosters is an act of last resort for record companies: "In today's difficult market, we have been forced to sign fewer new artists than we used to, and would like to." Kushner WDT at 4, RIAA Trial Ex. 62.

296. Indeed, one need only look at the historical performance of the record companies to know that this is the case. Linda McLaughlin compiled historical trends of record company spending from 1991 through 2005. CO Trial Ex. 41 at RIAA_0008423. While there are some year to year variations, the general trend is that record company spending on the "advances and recording" category (which, along with general overhead, is where most A&R spending originates), generally tended to rise throughout the boom years of the 1990s, from figures in the low to mid $200 millions to highs of $392 million in 1998 to $412 million in 1999. Subsequently, with the sharp downturn in industry fortunes, spending on A&R has declined as well, falling back to figures in the $200-$300 million range. CO Trial Ex. 41 at RIAA_0008423; *see also* Benson WRT at 8 & Figure 1, RIAA Trial Ex. 82 (showing figure of $246 million in 2006). As a result, as RIAA amply detailed in its opening findings, the record labels have been forced to substantially cut their artist rosters, to the detriment of record companies, music publishers and consumer alike. *See* RIAA PFF Section II.E.1.c.2.

297. The Copyright Owners do not address any of these facts, far less do they contradict them. Rather, they erect and rebut a straw man—namely, that RIAA cannot show a one to one correlation between the mechanical royalty rate and A&R spending. CO PFF ¶¶ 754-755. But RIAA has never purported to do that, and has no need to. The evidence at trial provides more than enough evidence for this Court to conclude that an increase in the mechanical royalty rate would lead to a reduction in the amount spent on A&R activities, while a decrease in the mechanical rate would have the opposite effect. The evidence has demonstrated that record companies think A&R spending is important, not only to the industry as a whole but to their own financial health. The evidence has demonstrated that A&R spending has historically varied with the financial fortunes of the record companies. And the evidence has demonstrated that the mechanical royalty rate has a considerable impact on the financial fortunes of the record companies, so much so that an increase of the magnitude sought by the Copyright Owners could even make the difference between a profitable and unprofitable venture. *See* RIAA PFF Section V.D.2.b. No more needs to be shown here.[15]

298. Finally, it should be pointed out that the Copyright Owners' entire argument here is a red herring. Record company expenditures lead to the greater availability of sound recordings in many ways, whether it be through A&R expenditures, marketing and promotion activities, or spending on manufacturing and distribution. Indeed, as witness after witness testified, the marketing and promotion activities of the record companies are critical to ensuring that sound recordings are, as a practical matter, "available" to consumers. As Mr. Barros

[15] The Copyright Owners assert that Ms. Santisi spoke to CFOs "at all four major record companies," (actually it was three companies) and that "none told her that a decline in the mechanical rate would lead to greater investments in artists and new recordings." CO PFF ¶ 755. But that simply was not a subject that Ms. Santisi discussed with the CFOs. 5/7/08 Tr. 5249:12-5250:2 (Santisi).

explained: "in order to release a recording, you have to market it." Tr. 2/21/08 4203:8-9 (Barros). And as Michael Kushner explained, without a massive promotional effort to connect an artist and recording with audiences, songs will never be known by the public in any meaningful way. Kushner WDT at 8, RIAA Trial Ex. 62. *See generally* RIAA PFF Section V.C.4.a.ii.

299. Thus, it makes little difference what portion of the savings from a mechanical royalty rate cut are put into A&R, marketing, or other record company activities. Either way, the additional activity enabled for the record company—"the R&D engine of the entire industry," Santisi WRT at 40, RIAA Trial Ex. 78—will work to the benefit of all.

7. The Copyright Owners Ignore the Devastating Effect of a Higher Mechanical Royalty Rate on Independent Labels.

300. The Copyright Owners almost entirely ignore independent record companies in their Proposed Findings of Fact even though they concede that independent record companies produce approximately 80% of all recorded music releases in the U.S. 2/21/08 Tr. 4106:10-13 (Barros); Emmer WRT at 4, RIAA Trial Ex. 90; *see also* Barros WDT at 5-6, RIAA Trial Ex. 74. *See* RIAA PFF ¶¶ 1132-1142.

301. To a certain extent, the Copyright Owners concede the imperiled position of independent record companies, acknowledging that independent companies are "not similarly situated to the large record companies," CO PFF ¶ 761, and are thus forced to pay higher distribution costs and are less able to negotiate discounts from the statutory rate. This latter concession means that the Copyright Owners must acknowledge the implausibility of their expert's testimony that transaction costs of negotiating discounts are low since, of course, they are not. *See* RIAA PFF ¶¶ 1086-1098.

302. Even worse, however, the Copyright Owners ignore the critical importance of independent record companies and their precarious situation in the current economy for recorded music. They suggest that Shout! Factory's shrinking margins result from Shout! Factory being a "niche" company. *See* CO PFF ¶ 761. But almost *all* independent record companies are niche companies. That is the very point of independent record companies. Both Mr. Barros and Mr. Emmer explained that the majors generally focus on "hit-oriented" recordings with widespread appeal to a large fan base in the most popular musical genres such as urban, pop, rock, and country. Barros WDT at 2, 5-6, RIAA Trial Ex. 74; Emmer WRT at 2, RIAA Trial Ex. 90; 2/21/08 Tr. 4105:11-13 (Barros) (explaining that independent labels "very often act as incubators for new music, experimentation"). Independent record companies locate, issue and market music in niche genres, and that is the very reason that independent record companies are responsible for the great diversity of music available to the public. Dismissing Shout! Factory as a niche company is the same as dismissing all independent record companies, and dismissing the significance of 80% of the recorded music releases made available to the public.

303. The Copyright Owners assert that Mr. Barros's company, Concord Records, has grown since the year 2004, something RIAA does not dispute. But Concord's very rare success is the exception, not the rule, and owes largely to a distribution deal between Concord and Starbucks that no other independent record company enjoys. Concord's ability to find success with Starbucks does not change the underlying conditions of the marketplace. 2/21/08 Tr. 4197:11-4198:9 (Barros).

304. The Copyright Owners assert that digital distribution has improved the market position of independent labels such as Concord, *see* CO PFF ¶ 759, but this conflicts blatantly with Mr. Barros's testimony that the distribution fee for digital music that Universal charges to

Concord Records is calculated at the same percentage rate that Concord is charged for physical CDs. 2/21/08 Tr. 4113:14-17 (Barros). Thus the costs of distribution do not affect the difference between the independent record companies' physical and digital margins. Barros WDT at 10, RIAA Trial Ex. 74. Moreover, the Copyright Owners ignore Mr. Barros's testimony that because Concord Music is a relatively large independent, it gets "a pretty good" distribution rate. Independents that are smaller wind up paying *higher* distribution rates to the major record companies. At the same time, they are making the same kinds of investment in new recordings that larger record companies make, so their margins are even smaller as a result. 2/21/08 Tr. 4201:13-4202:3 (Barros).

305. Finally, the Copyright Owners make much of the fact that Concord's mechanical royalty costs did not increase as much as its other costs, but they ignore that Concord was only able to cut its mechanical royalty costs *by decreasing the number of songs on the albums it released.* Glen Barros also testified about how under the current rate structure, Concord Records has reduced the number of tracks on some of its releases to manage its mechanical royalty cost. It used to be that if an artist recorded 15 or 16 tracks in the recording studio, and they were all good, Concord would put them on the album. Now, Concord actively seeks to reduce that number of tracks down to approximately 11 or 12 on average. 2/21/08 Tr. 4131:17-4132:3 (Barros). The first factor directs the Judges to set a rate that will maximize the availability of songs to the public, something the Copyright Owners neglect to consider in proposing a radical rate increase.

C. Music Publishers

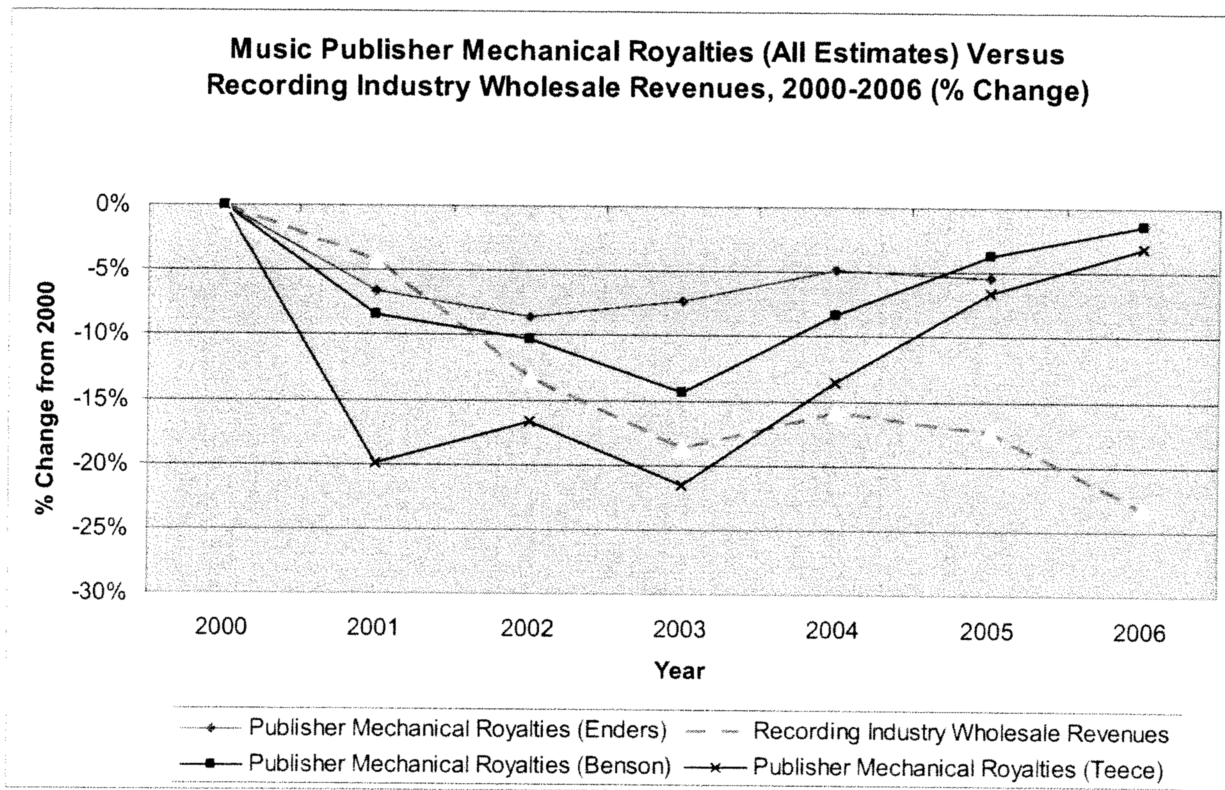
1. Mechanical Royalty Revenues Earned by Music Publishers Have Stabilized Even as Record Company Sales Revenues Continue to Decline.

306. The Copyright Owners contend that mechanical royalty revenues earned by music publishers "have generally been declining since 2000, notwithstanding the increases in the mechanical royalty rate that occurred in 2002, 2004 and 2006." CO PFF ¶ 257. Given the way that piracy has devastated the industry since the 1999/2000 period, there is nothing particularly noteworthy about that. What *is* noteworthy, as RIAA discussed in detail in its opening findings, is just how little (if at all) mechanical royalties have fallen since then, especially in light of the broader trends in the industry.

307. In fact, as the evidence showed, the change in mechanical royalty revenues since the 1999/2000 period has actually been quite minimal. *See generally* RIAA PFF Section II.E.2.a.i. The reason, as the Copyright Owners' own expert Claire Enders pointed out in a March 2007 report, is that recent increases in the mechanical royalty rate "have masked the underlying decline in recorded music sales." RIAA Trial Ex. 27 at 33. As RIAA demonstrated, thanks in large part to rising mechanical royalty rates, mechanical royalty revenues fell at first after the year 2000, but have since stabilized and are now back on the upswing. Thus, Dr. Teece showed a drop from $691 million in 2000 to $542 million in 2003, but steady growth thereafter to $670 million in 2006. RIAA PFF ¶ 369 & PFF Figure 29. Claire Enders showed a drop from $592 million in 2000 to $541 million in 2002, but steady growth thereafter to $560 million in 2005. RIAA PFF ¶ 373 & PFF Figure 33. And Bruce Benson's data showed a drop from $739 million in 2000 to $633 million in 2003, but steady growth thereafter to $729 million in 2006. RIAA PFF ¶ 377 & PFF Figure 36.

308. Moreover, as the evidence showed, the stabilization and steady growth that mechanical royalty revenues have experienced since the 2002/2003 period stands in stark contrast to what is happening with record company wholesale revenues. This is unusual because mechanical royalties are paid by the record companies out of their net sales revenue, and so the two have historically moved in tandem. Nonetheless, as RIAA RPFF Figure 4 below demonstrates (reproduced here from RIAA PFF Figure 39), while every estimate in the record shows that mechanical royalties turned the corner and headed upwards after 2002 or 2003, record company sales revenues have continued their descent:

RPFF Figure 4



Source: PFF Figure 39

309. Nor is this conclusion contradicted by the Copyright Owners' discussion of the financials of any of the individual publishers. As the Copyright Owners acknowledge, UMPG

showed modest growth in mechanical royalty earnings between 2000 and 2005, while Sony/ATV's mechanical royalty revenues were essentially flat, going from [ ] in FY2001 to [ ] in FY2006. CO PFF ¶¶ 262-263. The Copyright Owners place principal reliance on the results for EMI MP, Warner/Chappell and Famous, but a closer look at these numbers proves that they do nothing to change the conclusions that RIAA has drawn from these numbers.

310. First, for EMI MP, the Copyright Owners point to a decline of [ ] between FY 2001 and FY 2007. CO PFF ¶ 259. But as RIAA pointed out in its findings, this *entire* decline is attributable to the fact that EMI MP does not classify ringtone/mastertone income as mechanical royalty income. RIAA PFF ¶¶ 386-387, 390. The Copyright Owners fail to mention this in their proposed findings.

311. As for Warner/Chappell, the Copyright Owners show that *worldwide* revenues declined from [ ] in 2000 to [ ] in 2006, CO PFF ¶ 261, but they have no evidence as to the magnitude of the drop in the United States. They cite Ms. Santisi as conceding that there had been a "similar" decline in U.S. mechanical royalties, CO PFF ¶ 261, but this is simply a gross mischaracterization of the record. In the testimony attributed to Ms. Santisi, she does agree that there was a decline in domestic mechanical royalties during this time period, *see* 5/7/08 Tr. 5222:14-20 (Santisi), but Ms. Santisi never expressed an opinion on the magnitude of that decline. What's more, the publishers fail to acknowledge that Warner/Chappell's mechanical royalties, like those of EMI MP, are also artificially lowered by the classification of ringtone/mastertone revenues in the "digital" category as opposed to mechanicals. RIAA PFF ¶¶ 386-387, 390.

312. Finally, although the Copyright Owners assert that Famous Music Publishing's mechanical royalties declined from $16.6 million to $12.6 million between 2000 and 2006, CO PFF ¶ 260, they fail to note that Famous's mechanical royalties had stabilized by 2004 and remained steady since then. 1/31/08 Tr. 997:5-15 (Robinson). In any event, Famous only represented a small part of the market prior to its acquisition by Sony/ATV.

313. Thus, contrary to the music publishers' tales of woe, the evidence shows that they have largely recovered over the last several years, while the record companies continue to experience decline.

2. Music Publishers Contribute Little to the Product Made Available to the Public.

314. The Copyright Owners devote some 51 paragraphs in their findings to the supposedly "critical" role that they play in the development of talent. CO PFF ¶¶ 290-341. But as RIAA has already fully explained in its proposed findings, those contributions are minimal when compared to the contributions of record companies. In fact, as the evidence at trial showed, the music publishers were correct when they told their investors that "[m]usic [p]ublishing, as compared to the recorded music business, is a business of low capital intensity that requires significantly less operating costs, marketing and A&R expenses." RIAA Trial Ex. 51 at 23; *see also* RIAA Trial Ex. 13 at 17 (Famous prospectus with similar language).

315. As RIAA showed in its proposed findings, the expenditures of the record companies on the product made available to the public vastly outweigh those of the music publishers. Mr. Benson's analysis showed that the major record companies spend more than $1.3 billion a year on A&R expenses, including advances, recording costs, and the royalties paid to the artists who bring songs to life, $824 million on marketing, and more than $1 billion on manufacturing and distribution—and none of these costs includes the overhead of all the people

doing the functions described above. RIAA PFF ¶ 1318; Benson WRT at Fig. 1, RIAA Trial Ex. 82. By contrast, as Table A to Terri Santisi's report showed, the major music publishers' expenditures are only a small fraction of that amount. RIAA PFF ¶ 1316 & Table A. For example, EMI MP, until last year the largest music publisher, spent a paltry [ ] on advertising and promotion and [ ] on repertoire expense, not counting its overhead. RIAA PFF ¶ 1316.

316. In fact, the minimal contribution that music publishers make is reflected in the declining percentage of revenue that they retain from their writers. Music publishers used to retain, on average, 50 percent of the mechanical royalty revenues that their writers earned. But in recent years, that average has shifted in new deals to a 75/25 split in favor of the writer—and sometimes reaches an 80/20 or even a 90/10 ratio. RIAA PFF ¶ 1284; CO PFF ¶ 309. As the publishers themselves explain it, this is because songwriters are carrying more of the load in exploiting their songs, and publishers are doing relatively less. *See* 1/29/08 Tr. 505:15-507:5 (Faxon) (50/50 split moved to 75/25 because "songwriters became more active in the exploitation of their own music"). But the reason that songwriters have become more active in the exploitation of their own songs is precisely because their connections with the record companies, as singer-songwriters, enable them to do so. Thus, the shift from 50/50 to 75/25 is not just due to songwriters doing more vis a vis their publishers. It is a reflection of the fact that record companies are increasingly taking responsibility for the development and exploitation of songs away from the publisher. *See* RIAA PFF ¶ 1284 and citations therein.

317. The music publishers' minimal contribution to the creative activities of their songwriters is also reflected in their high profit margins and their near-perfect (in many cases 90 percent) recoupment rates on their advances. As amply detailed in RIAA's proposed findings,

the music publishers routinely enjoy profit margins in the 20 to 30 percent range—in stark contrast to the situation at the time of the 1980 CRT proceeding, when publisher profits were in the low single digits. *See* RIAA PFF Section II.E.2.a.iii. Those are profits that could be used to support songwriters and their creative activities, but are instead used to ensure that the publishers can boast to their investors about "stable growth, high-margin earnings and annuity-like cash flows." RIAA Trial Ex. 51 at 9. And the high recoupment rates that publishers earn on their advances just means that, unlike in previous times, music publishers are simply no longer taking the kinds of risks with their songwriters that they used to take. *See* RIAA PFF Section II.E.2.d.iii.

318. As a result, in virtually every single category of supposedly "critical" contributions that the Copyright Owners highlight in their proposed findings, those claims turn out, on close inspection, to be greatly overstated:

319. *Discovering Songwriters*. The Copyright Owners place a great emphasis on their supposed efforts in "discovering" songwriters, but their evidence fell woefully short. CO PFF ¶¶ 295-303. Typical of the publishers' failure of proof is the highly successful singer-songwriter Alicia Keys. Roger Faxon of EMI MP devoted considerable space in his written direct testimony to this supposed "example" of a singer-songwriter discovered by EMI MP. His written testimony contended that Jody Gerson of EMI MP "first learned about Alicia from an acquaintance in the music business when Alicia was only 14 years old." Faxon WDT at 12, CO Trial Ex. 3. He contended that EMI MP signed Ms. Keys and worked with her on her songwriting for a number of years, and that "[d]uring this period, Alicia signed with Columbia Records and recorded an album." Faxon WDT at 12, CO Trial Ex. 3. But at trial, RIAA confronted Mr. Faxon with evidence that in fact Ms. Keys had signed with Columbia Records

before she signed with EMI MP—and that the supposed "acquaintance" who introduced her to Jody Gerson *was none other than an executive at Columbia.* 1/29/08 Tr. 507:6-509:14 (Faxon). Not surprisingly, Ms. Keys—who figured so prominently in Mr. Faxon's testimony at trial—is now nowhere to be seen in the Copyright Owners' proposed findings.

320. Other examples that the Copyright Owners put forward were similarly weak. The Copyright Owners rehash the examples of James Blunt and Lance Miller, CO PFF ¶ 301, but as Ms. Santisi explained in her testimony, Lance Miller was a net loss for record company and music publisher alike, while James Blunt's success came only as a result of a multimillion dollar A&R and marketing investment on the part of his label. RIAA PFF ¶¶ 456-459. The Copyright Owners discuss the example of Linda Perry, CO PFF ¶ 303, but as Irwin Robinson of Famous candidly acknowledged at trial, by the time she signed with Famous, although she did not have a record deal, "somebody had financed the group to make a recording, and I am not sure it was a final recording, but at least it showed the 10 or 11 songs that were going to be on the record." 1/31/08 Tr. 959:5-8 (Robinson). That hardly counts as a writer whom Famous can claim to have first discovered. Apparently short on examples from the last several decades, the Copyright Owners even dust off an example from the 1950s—Buddy Holly, *see* CO PFF ¶ 302—but the evidence makes clear that it was a record company, not a music publisher, that first had Mr. Holly under contract. CO PFF ¶ 302; Peer WDT at 5-6, CO Trial Ex. 13.

321. It is no surprise that the music publishers have had such trouble providing examples of successful songwriters that they have discovered. As RIAA detailed in its findings, music publishers' A&R spending is simply dwarfed by that of the record companies. EMI MP was until last year the largest music publisher, with a total A&R budget in the U.S. of more than [ ] and annual gross advances in the U.S. averaging close to [ ] per year.

Faxon WDT at ¶¶ 12, 16, CO Trial Ex. 3. But those figures pale in comparison with the comparable figures from the largest record company, Universal, which in 2006 had gross spending on A&R of [ ]—many times more. And even these figures understate the comparison because Mr. Faxon's figures for A&R and developmental activity spending include not only third party expenditures but also all overhead expenses (such as salaries and rent) that could be allocated to these activities. Faxon WDT at Ex. 201 & 205, CO Trial Ex. 3. In a true apples to apples comparison, UMG's A&R overhead of [ ] would need to be counted, plus whatever significant portion of UMG's [ ] general and administrative overhead is allocable to the management and support of their creative efforts. Santisi WRT at 11, RIAA Trial Ex. 78. *See generally* RIAA PFF ¶¶ 452-454.

322. A second reason that music publishers' contribution to the discovery of new songwriters is so paltry is that, as was documented in RIAA's proposed findings, they deliberately seek out catalog and administration deals—arrangements in which they can tap into a steady stream of revenues, rather than having to take a risk on a new artist. RIAA PFF Section II.E.2.d.ii. And when they do sign new talent, they tend to prefer writers who already have record contracts (with controlled composition clauses)—something that, in this age of the singer-songwriter and the producer-songwriter, is increasingly easy for them to do. RIAA PFF ¶ 464. Nothing in the Copyright Owners' proposed findings suggests the contrary. The only evidence that the Copyright Owners are able to muster is Nicholas Firth's testimony that out of the 42 new songwriters that BMG MP signed in 2005, 27 had not yet released a commercial record. CO PFF ¶ 295. But that just proves RIAA's point—15 of those supposedly "new" songwriters had already had a commercial release, and it is very likely that some if not most of the other 27 were already under contract with a record company, even if their record had not yet been released.

323. *Financial Support to Songwriters.* The Copyright Owners talk at length about their advances to songwriters, but they exaggerate both the size and the importance of those advances. In fact, as the evidence showed, music publisher advances are not as large as the publishers say they are, and they are not nearly as significant to the careers of songwriters as they claim.

324. As to the size of music publisher advances, the Copyright Owners give a wide variety of numbers, ranging from typical advances of $40,000 to $50,000 for Famous songwriters to advances of up to $1 to $2 million in the case of pop and urban songwriters. CO PFF 308. But what the Copyright Owners fail to disclose is that a large portion of these advances do not go to songwriters at all, but rather are advances on catalog or administration deals. As Terri Santisi explained, these types of advances are not given to support the creation of new works at all, but are simply given as an advance payment on an earnings stream of *already-existing works* that is already well-established by the time the music publisher gets involved. RIAA PFF Section II.E.2.d.i. Deals of this nature can be a significant portion of a publisher's portfolio—for example, [█] of Warner/Chappell's worldwide catalog is administered. RIAA PFF ¶ 443; Santisi WRT at RIAA Ex. 126-RR at 4, RIAA Trial Ex. 78. Thus, the amount that the music publishers actually advance to further the writing of songs is far less than the Copyright Owners would have this Court believe.

325. Moreover, many of these advances go to writers who need them the least—writers that are either already well-established or who have *already* signed a record deal or released an album. For example, Irwin Robinson of Famous Music testified that the largest deal Famous made was a $15 million advance to recording star Shakira—*after* she already had a hit album. 1/31/08 Tr. 965:12-20 (Robinson). And as the Copywriter Owners themselves candidly admit,

publishers generally give bigger advances to songwriters under contract with a label, and they frequently tie those advances to the commercial release of albums. CO PFF ¶ 306-307; RIAA PFF ¶¶ 464-467. Advances that are structured this way do not support songwriters in the initial phases of their career—to the contrary, they leave to *record companies* the increasing responsibility to do just that.

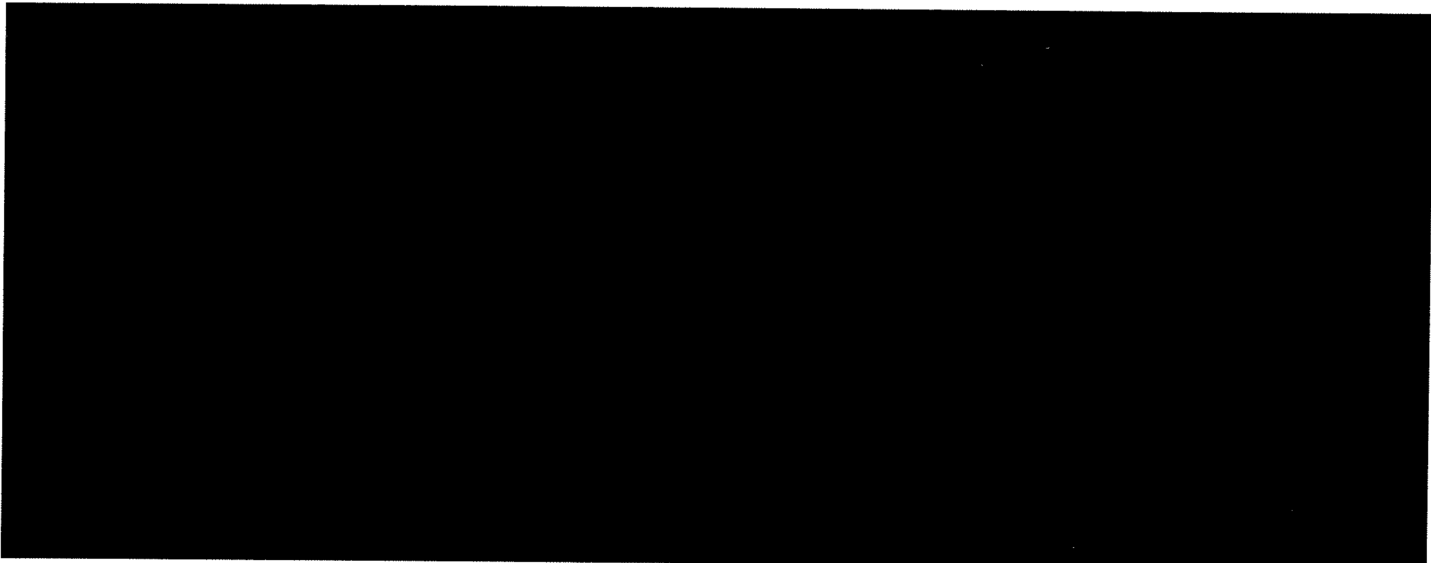
326. Perhaps the best indication of the paltry contribution the music publishers make with their songwriter advances is that they regularly recoup as much as *90 percent* of these advances year after year, as Terri Santisi documented in her report. RIAA PFF ¶¶ 473-483. Given that the vast majority of new artists fail, one would expect that anybody in the music business who is regularly placing bets on the success of new artists and songwriters with no track record of success would recoup a far lower percentage of their advances. And, indeed, as Ms. Santisi testified, the record companies have recoupment rates that are much lower. RIAA PFF ¶ 463. The fact that the music publishers are regularly recouping far more of their advances can only mean one thing: unlike the record companies, they are not taking substantial risks with unproven talent.

327. Notwithstanding the painstaking detail with which Ms. Santisi demonstrated the advance recoupment rates of the publishers, the Copyright Owners persist in contending that the publishers have low recoupment rates. For example, they tender Mr. Faxon's testimony that at year end 2005, EMI MP estimated that approximately [REDACTED] out of [REDACTED] in outstanding advances would not be recouped. CO PFF ¶ 316. The Court should not be misled by this testimony. As Ms. Santisi explained, the [REDACTED] is a gross figure made up of two different components: (1) newly-made advances that are too new to be recouped; and (2) older advances that have not been recouped and likely never will be—a figure which has been

accumulating on EMI MP's books for years and which is carried forward from year to year. 1/30/08 Tr. 602:5-15 (Faxon); *see also* 1/30/08 Tr. 602:10-13 (Faxon) ("Q. This is the place where all the bad decisions people have made over the years pile up and sit? A. Yes, I'm afraid it is."). It is not surprising to hear that half of this total figure is considered unlikely to be recouped, but that says nothing about the percentage of EMI's total advances that are recouped.

328. Lest there be any doubt about EMI MP's recoupment rates, RPFF Figure 5 below, an excerpt from EMI MP's books, shows it in black and white. Line 42922 of that exhibit, which is outlined in black, shows the "TOTAL ADVANCES" made by EMI MP in each year, beginning with FY 2007 on the left and ending with FY 2000 on the right. Line 42924, also outlined, shows the "TOTAL RECOUPMENT" for each of those years. Simple math—performed by Terri Santisi in her testimony and utterly unchallenged by the Copyright Owners during Ms. Santisi's cross examination—shows that for the eight-year period in question, EMI MP made [ ] in gross advances and recouped a total of [ ], or 91.0% of the total gross advances. Santisi WRT at 14, RIAA Trial Ex. 78.

RPFF Figure 5 -RESTRICTED



329. As RIAA showed in its proposed findings, similar problems plague the Copyright Owners' other efforts to show low recovery rates. For example, the Copyright Owners claim that BMG MP has written off approximately 55% of its advances, CO PFF ¶ 316, but as RIAA has already showed, this is contradicted by BMG MP's books and records and appears to be based on the same misleading comparison as the EMI MP number. RIAA PFF ¶¶ 478-479 (showing that Mr. Firth's testimony, like that of Mr. Faxon, appears to have compared the outstanding balance at any one time with the total amount of advances written off over many years). Similarly, the Copyright Owners point to Dr. Landes's testimony about the purported low recoupment rates for EMI MP, but his evidence too was weak. Although Dr. Landes suggested in his testimony that he was examining the percentage of EMI MP's advances in 2002 that had been recouped by 2006, he admitted on the stand that he was including advances made in 2003, 2004, 2005 and 2006 as well—advances that would naturally have a much lower chance of being recouped by 2006. RIAA PFF ¶ 476. Indeed, even Dr. Landes admitted that his phrasing on this point had been "ambiguous." 5/20/08 Tr. 7360:4-7 (Landes).

330. *Creative Support to Songwriters*. The Copyright Owners discuss the creative support that publishers give to songwriters, but there is slight evidence of this. The Copyright Owners proffer a largely descriptive evidence of the type of work they do for their writers, but their evidence is almost entirely bereft of anything that would *quantify* these efforts. And the few numbers they do offer shows that their contribution is in fact very small. The Copyright Owners discuss the $100,000 studio that one of the publishers built for its writers, CO PFF ¶ 319, but the record companies regularly spend many times over for the recording costs of just one of its artists alone. *See, e.g.*, RIAA PFF ¶ 457 (discussing [REDACTED] recording fund that Atlantic Records established for James Blunt). And the Copyright Owners mention that BMG

MP had two employees dedicated to facilitating co-writing opportunities, CO PFF ¶ 320, but that utterly pales in comparison to the A&R staffing at major record companies. *See* 2/14/08 Tr. 3444:16-18 (Kushner) (there are 20 people in the A&R department of Atlantic Records, which is just one of the Warner labels).

331. In fact, as RIAA demonstrated in its proposed findings, the rise of the singer-songwriter means that the record companies are playing a much larger role in the actual writing of songs than they used to, taking over roles that used to be held by the publisher. *See generally* RIAA PFF Section V.C.3.b. Moreover, as Dr. Teece explained, even for those recording artists who do not write their own songs (*e.g.*, many in the pop, R&B, and country genres), the role of finding songs to record is performed primarily by the A&R staff, managers and record producers who are working with the recording artists, albeit with input from publishers. Teece WDT at 105, RIAA Trial Ex. 64. And as Michael Kushner explained, producers, funded by record companies, often work with artists to write tracks to be used on albums. And much of this work is done in the studio, paid for by the record companies and supervised by their A&R departments. Kushner WDT at 6-7, RIAA Trial Ex. 62

332. *Promoting Songwriters' Works*. The Copyright Owners talk about how publishers promote songwriters' works, but this passage of their proposed findings is also largely descriptive and bereft of quantitative analysis. And again, the little quantitative analysis that the Copyright Owners do provide only proves RIAA's case. The Copyright Owners note that EMI MP, until last year the largest publishing company, spent [ ] on development and promotional activities in 2006. CO PFF ¶ 332. But as RIAA pointed out in its findings, this figure is absolutely trivial in comparison to the marketing and promotional spending of the record companies. *See* RIAA PFF ¶¶ 452-453 (the largest record company, Universal, spent

[ ] in marketing, in additional to [ ] in marketing overhead, in 2006 alone).

333. Moreover, as RIAA noted in its proposed findings, record company producers and A&R personnel are increasingly taking over the principal tasks of finding songs for their artists to record. Indeed, time after time, record company executives say that they rarely get calls from music publishers seeking to promote songs. *See* RIAA PFF ¶ 1280 (Barros); RIAA PFF ¶ 1280 (Emmer); RIAA PFF ¶ 1283 (A. Finkelstein). And as RIAA has explained, this is precisely why songwriters are willing to pay music publishers less of a share of their royalties than ever before—because songwriters, thanks to their direct ties with record companies, are now finding the promotional efforts of publishers to be less relevant. RIAA PFF ¶ 1284; 1/29/08 Tr. 505:15-507:5 (Faxon).

334. *Providing Administrative Support to Songwriters.* Finally, the Copyright Owners tout the music publishers' administrative support for songwriters, such as administering licenses and collecting royalties. As with most of their other contributions, these are also not quantified. But there is certainly every reason to think that the expenses of these activities are minimal. For example, the Copyright Owners say that "[a]mong the most important administrative duties is copyright registration, including with the U.S. Copyright Office and international collecting societies." CO PFF ¶ 334. Yet U.S. copyright legislation requires only submission of a simple form and payment of a small fee, 37 C.F.R. §§ 201.3, 202.3, and the amount the publishers appear to spend on this activity is minimal – according to the records of EMI MP, copyright registration cost a total of [ ] in FY 2000 and [ ] in FY 1999, apparently the only two years these expenses were tracked. RIAA Trial Ex. 8 at CO04024791 at line 4125400.

3. Thanks to Their Multiple Streams of Revenues and Little Spending, Music Publishers Take Few Risks with Their Capital.

335. As RIAA has shown in its proposed findings, record company risk far surpasses music publisher risk. This is for a number of reasons. For one, music publishers have been insulated from declining music sales by the recent lockstep increases in the mechanical royalty rate. RIAA PFF Section II.E.2.a.i. Second, music publishers have been able to count on greatly increasing revenues from nonmechanical lines of revenues, giving them a largely cost-free infusion of cash for their bottom lines. RIAA PFF Sections II.E.2.a.ii & II.E.2.d.iv. Third, music publishers have very little overhead or other expenses, other than songwriting advances. RIAA PFF Section II.E.2.d.ii. Finally, music publishers structure their relationships with their songwriters to ensure that they invest money only when those songwriters have shown a high likelihood of success, such as when they sign a record deal or release an album. RIAA PFF Section II.E.2.d.iii.

336. Notwithstanding this evidence, the Copyright Owners still persist in contending that music publishing is *not* less risky than the recorded music business. CO PFF Section XV.E.5. But their arguments have little merit.

337. The Copyright Owners first take issue with Dr. Teece's analysis of the relative volatility of EMI's recorded music and publishing businesses. CO PFF ¶¶ 790-793. The Copyright Owners' main complaint is that EMI is a bad example because EMI Music's performance lagged the rest of the industry. CO PFF ¶ 792. But as RIAA showed, the results are the same no matter what companies one examines. Terri Santisi's analysis showed that throughout the 2000-2006 period, the profit margins and revenues of the major publishing companies remained exceptionally stable. Indeed, every major publisher had positive profit margins in every single year, and every major publisher had double-digit profit margins in all but

one year. RIAA PFF ¶ 436. By contrast, record company profit margins have been far more volatile. Indeed, even on an aggregated basis—*i.e.*, one that would smooth out large swings in one company's profits or another's—the profit margins of the major record companies have varied more wildly than any *one* of the major music publishers. *See* RIAA PFF ¶ 1324; Benson WRT at 8 & Figure 1, RIAA Trial Ex. 82. On an individual basis, of course, record company profit margin volatility far exceeds that of the publishers. RIAA PFF ¶ 1324.

338. The Copyright Owners' second critique of these conclusions is that record companies have simply "chosen to rely on an inherently risky business model." CO PFF ¶ 796. Presumably the Copyright Owners think that record companies could simply decide not to take any more risks with their capital, and invest only in artists who are established or who are otherwise somehow "safe." But that makes no sense. Taking risks on unproven artists, even if it means losing money more often than not, is precisely what enables record companies to make the tremendous contributions that they make each day to the rich fabric of American music. Presumably the Copyright Owners would rather the record companies become more like modern-day music publishers, collecting catalogs and investing only in proven artists and otherwise running their companies like annuity businesses. But that would serve nobody's interests, least of all songwriters and music consumers.

339. Moreover, that the record companies face greater risks than the music publishers demonstrates, as Dr. Slottje explained, that the returns being earned currently by record companies and music publishers are upside-down, driven in part by the excessive statutory rate. As Dr. Slottje explains, basic economic theory predicts that the party that organizes all of the resources and takes the most risks (the record companies) should earn the greatest profit margin. Slottje WRT at 12-13, RIAA Trial Ex. 81. In the current market, however, the reverse is true—

record companies take far more risk, but earn far less in terms of profit margin than music publishers.

4. Piracy Affects Music Publishers Far Less Than It Affects Record Companies, and Music Publishers Contribute Far Less to the Fight Against Piracy Than Record Companies.

340. The Copyright Owners say that "piracy has had severe and adverse effects on songwriters and music publishers," CO PFF ¶ 801, but the evidence presented by RIAA in its proposed findings made clear that the effect of piracy on music publishers is actually far less than it is on record companies. As RIAA explained, this is for two reasons. First, the rising mechanical royalty rate has insulated music publishers from the worst effects of piracy because mechanical royalties have stabilized since 2002 and are now on the rise—quite unlike the situation experienced by record companies. RIAA PFF Section II.E.2.a.i. Second, the music publishers' skyrocketing revenues from performance and synchronization—revenue streams that are unaffected by piracy—have given the music publishers a level of protection against piracy that the record companies do not enjoy. RIAA PFF IV.E.2.b.

341. The Copyright Owners suggest that they "have made significant efforts to fight piracy," CO PFF Section XV.E.6, but they fail to quantify those efforts. The only thing they are able to say is that they have been actively involved in high-profile piracy lawsuits and that they have taken a lead role in one of them. CO PFF ¶ 800.

342. But in fact, as RIAA showed in its proposed findings, the actual amounts spent on anti-piracy activities are considerably different for the record companies and the music publishers. RIAA's antipiracy spending between 2000-2006 was about $174 million, or an average of about $25 million per year, Bassetti WDT at 14, RIAA Trial Ex. 68, and spending during that period has increased year-to-year. 2/20/08 Tr. 3927:21-3928:3 (Bassetti). By

contrast, the total amount that the NMPA spent on *all litigation*—including anti-piracy as well as other actions, such as this one—was roughly $5 million in 2005 and $8 million in 2006. RIAA Trial Ex. 18 at 3; 1/31/08 Tr. 1036:12-15 (Robinson). *See generally* RIAA PFF Section V.C.5.c.

D. The Digital Music Marketplace

343. The Copyright Owners contend that a decreased rate is not necessary because, according to them, the digital market is not nascent and does not need encouragement to develop in the future. CO PFF Section XVI.C. Their entire position, however, is centered on the growth of Apple's Itunes Store. Even if true, the only thing the Copyright Owners' arguments would prove is that Apple has developed its *company*, not that the digital marketplace is fully developed.

344. DiMA discusses other companies in the market for digital music distribution. DiMA PFF Section V.A. By contrast, in the entire Section XVI.C in which the Copyright Owners contend that the digital music marketplace is well-developed and no longer nascent, there is but one solitary paragraph mentioning any digital music service other than Itunes. CO PFF ¶ 835. There is no discussion about whether the *market* conditions are such that entry and exit of new services is encouraged. Rather, the Copyright Owners rely on the rather obvious fact that if Apple's Itunes does not have 100% market share, then that means that other services *exist*. The Copyright Owners overlook the undeniable basic notion that the success of one company does not itself determine the development of an entire market.

345. As RIAA has discussed elsewhere, the very purpose behind Section 115 is to encourage new entrants into the market for the use and distribution of music. RIAA COL Sections I.A & II.A.1. Thus, the Copyright Owners tiresome refrain of "Look to Apple" does little to satisfy the concerns of Section 115's statutory objectives. This refrain merely suggests,

if anything, that the coming years will be crucial for the digital marketplace to determine whether new digital music services will be able to meaningfully enter the market for permanent downloads. The purpose and history of Section 115 therefore requires this Court to be especially sensitive to encouraging the growth of the digital market.

346. Given the economic reality that the digital marketplace is still developing and there can be little certainty about the entry and exit of new digital music services, there is no evidence in the record to suggest that the party that will ultimately bear the brunt of any purported rate increase is anyone other than the record companies. As detailed in RIAA RPFF Section IV.B, this past decade has been a difficult one for the record companies and those harsh economic conditions will continue into the future. Knowing full well that the record conclusively establishes that the record companies have suffered greatly, the Copyright Owners have shrouded their request to make the record companies suffer more behind their claim that a fully developed digital market can absorb the loss.

V. THE STATUTORY FACTOR ANALYSIS SUPPORTS RIAA'S RATE AND TERMS PROPOSAL.

347. The Copyright Owners have presented no proposed findings of fact with respect to the four statutory factors set forth in Section 801(b). Rather, they have advanced noncomparable benchmarks and simply ignored that Section 801(b) compels the Judges to analyze the statutory factors to determine whether and how they counsel in favor of adjusting the benchmark rates.

A. First Objective -- Maximizing the Availability of Creative Works to the Public

348. The Copyright Owners have failed to demonstrate that an increase in the mechanical rate is needed to maximize the availability of creative works to the public, or that

lowering the rate will reduce the availability of creative works to the public. Indeed, the Copyright Owners barely even consider the first statutory factor in their Proposed Findings of Fact. To the extent that they address this factor at all, the essence of their argument is that "an increased mechanical royalty rate likely will increase not only the number of songwriters, but also the number of musical compositions produced." CO PFF ¶ 283.

348. This argument fails for several reasons, not the least of which is that the purpose of Section 801(b)(1)(A) is not to maximize the number of songs written; rather, its purpose is to maximize the *availability of creative works to the public.* The Copyright Owners do not come to terms with the reality that songs are only made available to the public if they are recorded and if those recordings are marketed and distributed to the public—invariably by record companies. Without record companies, songs are not made available to the public, even if a million more songs are written today than yesterday. RIAA PFF ¶¶ 1108-1113.

349. Even assuming that a higher mechanical rate would increase the flood of songs that are already being written and offered to record companies—and that supposition is not supported by the evidence—the additional cost imposed on record companies will only cause them to reduce the production of recordings. If record companies cannot cover their costs, the incentive to produce new recordings is diminished and in the end, record companies, publishers and songwriters alike will be worse off. 2/19/08 Tr. 3648:9-19 (Teece) (explaining that this is not a "zero sum" game and unless the record companies can succeed, no one in the chain of production will succeed); *see also* 2/11/08 Tr. 2502:9-22 (Landes) (admitting that in applying the first factor, one also has to consider the decline in recordings because that affects the availability of new songs to consumers).

350. There is absolutely no reason to believe that there is a shortage of songs. In fact, there are literally millions of songs available to be recorded. RIAA PFF ¶¶ 74-79, 510-511. Rather, as the unrebutted evidence shows, the problem is that the current mechanical royalty rate is already imposing substantial limits on the number of albums being recorded and the number of songs being included on new albums. Artist rosters are being cut, RIAA PFF ¶¶ 1117-1119, fewer albums are being released, RIAA PFF ¶¶ 1120-1121, and fewer tracks are being included on albums. RIAA PFF ¶¶ 1122-1125. As Glen Barros put it, "Mechanical royalties are one of our most significant cost items, and at 9.1 cents per track, we often need to limit the number of tracks we put on an album because of excessive mechanical royalty costs." Barros WDT at 5, RIAA Trial Ex. 74. Raising the mechanical rate will only exacerbate this problem and decrease the availability of creative works to the public.

351. The Copyright Owners do not dispute that the supply of new *recordings* is decreasing under current market conditions. 2/11/08 Tr. 2502:20-22 (Landes). Indeed, they note that trends in the market "have led to fewer business opportunities for songwriters" —*i.e.*, fewer opportunities to get their songs recorded. CO PFF ¶ 240. Nor do they deny that there is already a massively larger supply of songs than is needed to fill every album recorded. Faxon WDT at 42, CO Trial Ex. 3.

352. Their answer seems to be that what is missing is a sufficient supply of *quality* songs. CO PFF ¶ 285 ("Increasing the mechanical royalty rate will also improve the quality of songwriters' compositions."). But that again ignores the express language of Section 801(b)(1)(A), which seeks to maximize the "availability" of creative works to the public, not to maximize the quality of compositions.

354. In any event, there was no showing at trial that there is any shortage of high-quality songs. Indeed, the evidence is to the contrary. Teece WDT at 84, RIAA Trial Ex. 64 ("No A&R executive with whom I spoke was aware of any difficulty in finding an appropriate song when one was needed.") Nor is there any credible evidence that improving the quality of compositions would result in more recordings being made available to the public, or that an increase in the mechanical rate will improve the overall quality of the songs that are recorded. Since most new songs that get recorded were written by the artist performing them, there are already very substantial incentives, even apart from mechanical royalties, for the writers of those songs to do as good a job as possible. And it simply is not credible that artists who stake their careers on each new release are not writing the best songs they can.

355. Even for pure songwriters not driven by a desire to produce their own high-quality recordings, the evidence suggests that their incentives to create quality material would not be significantly affected, one way or the other, regardless of whether this Court raises or lowers the mechanical rate. There is already an over-abundance of songs being offered in the marketplace, for at least two reasons.

356. First, songwriting is an activity that people enjoy regardless of the monetary compensation they may receive. Hedonic wage theory makes clear that nonmonetary motivations play a major role in diverting people from some jobs and into others. RIAA PFF ¶¶ 1165-1170.

357. Drawing on a reference in the 1981 CRT decision to "psychic reward[s]," the Copyright Owners argue that these kinds of nonmonetary motivating factors should not be considered in setting the mechanical rate under the factors set forth in section 801(b)(1). CO PFF ¶ 772. But that is clearly wrong. Under the first statutory factor, the Court's job is to assess

whether the rate needs to be adjusted to maximize the availability of creative works to the public. Any causal factor that affects the availability of creative works, therefore, cannot be ignored. The 1981 CRT decision did not hold that Section 115 bars the consideration of psychic income in evaluating songwriter incentives. Rather, the CRT indicated that psychic reward cannot be the *only* reward offered. *1981 Mechanical Rate Determination*, 46 Fed. Reg. at 10479.

358. Moreover, in free markets, hedonic wages, also known as psychic income, are not ignored. As Professor Slottje explained, employers seeking to fill dangerous or unpleasant jobs in the free market have to pay more. The converse is also true. Slottje WRT at 23, RIAA Trial Ex. 81. *See also* RIAA PFF ¶¶ 1166-1168.

359. The Copyright Owners also claim that Professor Slottje's testimony about hedonic wage theory lacks empirical support. CO PFF ¶¶ 772-775. But it does not require an extensive empirical study for an economist to testify that one of the factors affecting participation in a given form of employment is the non-financial benefits participants feel. Nor is such a study required to conclude that the non-financial benefits of songwriting are relatively large. And even if it were, Professor Slottje cited statistics that quantify some of the non-monetary benefits of songwriters, and research showing that artists value highly the psychic income of having their creative works performed and appreciated. Slottje WRT at 23, RIAA Trial Ex. 81. *See also* RIAA PFF ¶ 1169.

360. But the strongest evidence supporting the hedonic wage theory comes from the songwriter witnesses themselves. As set forth in RIAA Proposed Findings of Fact, the songwriters presented extensive testimony that they do not write songs just to make money and that they obtain other non-monetary benefits from it. RIAA PFF ¶ 1170.

361. Second, lowering the mechanical royalty rate is unlikely to decrease the availability of creative works to the public because songwriters are motivated much less by their immediate earnings than by the small chance that they will achieve huge success. The Copyright Owners dispute this fact, calling it "contrary to the most elementary principle of economics." CO PFF ¶ 777.[16] But their own primary economic expert, Dr. Landes, unequivocally testified that "one thing you're doing as a songwriter is looking at the prospect that you're going to be a very successful songwriter. It's a little bit like drilling for oil . . . ." 5/20/08 Tr. 7344:7-10 (Landes). Professor Landes added that the "main effect" of a rate increase on the incentives experienced by the vast bulk of songwriters would be caused by an increase in the value of winning the "tournament" and becoming highly successful. 5/20/08 Tr. 7345:14-18 (Landes). In fact, the songwriter witnesses testified that they fully understand that there is little chance that any given song will become a hit and, at the time the song is written, do not know whether it will be a hit or not. RIAA PFF ¶ 1184. And yet they still keep writing because, as Dr. Slottje testified, they hope to win the tournament.

362. As Professor Slottje pointed out, given how lucrative it is to become one of the songwriting elite who earn millions of dollars, there is little reason to think that the incentives experienced by the vast bulk of songwriters would be meaningfully affected by an increase or a decrease in the mechanical rate. RIAA PFF ¶¶ 1181-1183. Certainly the Copyright Owners made no effort to show that the supply of quality songs would be measurably affected if the annual mechanical royalty income of the top 1% of songwriters, estimated by Dr. Landes to be at

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[16] The Copyright Owners claim that Dr. Slottje "conceded" that tournament theory is "contrary to the most elementary principle of economics that supply increases with price." CO PFF ¶ 777. That is a fundamental mischaracterization of his testimony. Dr. Slottje did not state that tournament theory contradicts principles of economics.

least a half a million dollars and often much more, Landes WRT at 9, CO Trial Ex. 406, were increased.

363. In addition, the Copyright Owners' supposition that quality will rise with an increase in the mechanical rate seems to presuppose that such an increase will in fact cause the income of individual songwriters to increase significantly. CO PFF ¶ 226 ("Ms. Sharp explained that '[i]t is extremely difficult, if not impossible, for songwriters to produce quality songs when they are focused on how to pay the bills.'"); CO PFF ¶ 285 ("Ms. Sharp explained that even an increase of a penny in the mechanical royalty rate would help her 'to make artistically driven choices rather than financially driven choices.'"). But as Dr. Landes acknowledged, there is every chance that an increase in the rate, even if it does induce more people to spend more time writing songs, will just cause the increased payments made by the record companies to be spread among more writers, dissipating any individual benefit. 5/20/08 Tr. 7287:9-14 (Landes).

364. This dissipation effect would combine with the reality that there are already many more songs than there are recording opportunities, which causes songwriters to accept discounted mechanical rates to get their songs recorded. Because that would not change, some of the effects of any rate increase would be blunted by continued, and likely increased, discounting, although discounting would also continue to be limited by the transaction costs of negotiating discounted rates.

365. For all of these reasons, the Copyright Owners' arguments about creating needed incentives for songwriters are entirely misplaced and do not justify raising the mechanical rate to satisfy the first statutory objective. To the extent that the first statutory factor suggests any adjustment of the rate, it supports a reduction.

B. Second Objective -- Fair Return to the Copyright Owners and Fair Income to the Copyright Users Under Existing Economic Conditions

366. The Copyright Owners do not present a single proposed finding of fact that purports to address this factor, and with good reason. A rate decrease is compelled by existing economic conditions in the music industry, in which sales and revenues for the record companies are declining while songwriters are prospering and music publishers are enjoying record profits. RIAA PFF Section V.B.1. Moreover, balancing the need for a fair return for the record companies against the need for a fair income for songwriters and music publishers also compels a reduction in the rate. The record companies cannot earn a fair return at present rates because the statutory rate is now a higher percentage of the wholesale price of CDs than ever before, causing record companies to struggle with their bottom lines. RIAA PFF Section V.B.2.a. Meanwhile, songwriters and music publishers are earning far in excess of a fair income because the present rate structure has insulated them from royalty decreases even while the retail price of music is in a free-fall. RIAA PFF Section V.B.2.b.

1. Existing Economic Conditions Confirm the Need to Decrease the Mechanical Rate.

367. As RIAA explained in its proposed findings, the "existing economic conditions" that the statute provides should be controlling are as follows:

- In recent years, the mechanical and total royalty income streams of publishers and songwriters have held steady or increased, as the revenues earned by record companies on sales of recordings have plummeted.
- Publishers continue to earn very high profit margins, usually in the range of 25-30%.
- The reported profit margins of record companies are much smaller than those of the publishers, and the profits in the aggregate reported on the record company P&Ls do not account for all the restructuring charges the record companies have taken in recent years— restructuring charges which the publishers have not suffered.

- Songwriters' average income from mechanical royalties has increased well above the rate of inflation since 2003.

- Retail and wholesale prices for sound recordings (especially CDs) are and continue to decline.

- Record companies have cut all of their costs, but have been unable to reduce the cost of mechanical royalties. It is the one cost that has increased in absolute terms since 1999.

- Mechanical royalties are a greater percentage of total wholesale revenues and per unit wholesale revenues than at any point in recent memory.

- The U.S. statutory mechanical rate has gone from being one of the lowest in the world to one of, if not the, highest in the world.

See RIAA Reply PFF Section V.B.1.

368. As to the record companies' sales and revenues, the Copyright Owners could not, and do not, meaningfully dispute that retail sales are plummeting and that wholesale revenues are likewise continuing to fall. The Copyright Owners do suggest that things will improve in the near future, but as RIAA has amply explained, these arguments have little basis. For example, the Copyright Owners suggest that the current downturn is just like every other past cycle of technological change. But as the record demonstrates, the downturn is far worse and far more long-lasting and transformative than any format change in recent history. RIAA RPFF Section IV.B.1. The Copyright Owners also point to rising digital revenues, but they ignore the fact that those digital revenues are rising nowhere near fast enough to replace falling physical sales. RIAA RPFF Section IV.B.4.a.

369. As to songwriter and music publisher revenues, the Copyright Owners also do not seriously challenge RIAA's presentation. The Copyright Owners contend that music publishers' mechanical royalties have declined since 2000, but they do not rebut RIAA's showing that thanks to rising mechanical royalty rates: (a) this decline was minimal at best; (b) since 2002 or

2003, mechanical royalties have been on the upswing; and (c) the decline in mechanical royalty revenues, if any, was far less than the drop in record company wholesale revenues. RIAA RPFF Section IV.C.1. Nor do the Copyright Owners even attempt to challenge RIAA's conclusion that music publishers' revenue is skyrocketing when other forms of revenue, including performance and synchronization, are taken into account. Songwriters' royalty revenue continues to grow at a steady rate faster than that of inflation. Although the Copyright Owners suggest that songwriter revenues are in decline, the evidence wholly rebuts that assertion. RIAA RPFF Section IV.A.

370. As to record company costs, the Copyright Owners have suggested in their proposed findings that record company costs other than mechanicals have been on the increase, but that is based on a deceptive manipulation of the numbers in the record. In fact, as RIAA has pointed out in these findings, since 1999 the record companies have reduced their expenditures in every single category of costs except the one over which they have least ability to control, namely mechanical royalties. RIAA RPFF Section IV.B.2.

371. As to wholesale and retail prices, RIAA showed that prices have declined, and the Copyright Owners do not, and cannot, offer any evidence to rebut that conclusion. Nor can they rebut the conclusion that the ratio of mechanical royalties to the wholesale price has been steadily rising, and has now reached a historic high. *See* RIAA RPFF Section IV.B.2.

372. Finally, as to profit margins, the Copyright Owners offer no evidence whatsoever to rebut RIAA's showing that music publishers have enjoyed steady margins in the 20-30 percent range, and that those margins are orders of magnitude higher than the margins music publishers had when the CRT considered mechanical royalty rates in 1980. As to record company margins, the Copyright Owners' suggestion that the record companies have earned "record profits" is wholly belied by Mr. Benson's summary of record company financials as well as the concession

by their own economic witness that the cost of record company restructurings has exceeded the total profits earned by the record companies since 2001. RIAA RPFF Section IV.B.3.

2. A Fair Return for Copyright Owners and a Fair Income for Copyright Users Must Equitably Divide the Profits of the Music Industry Between Copyright Owners and Record Companies.

373. Given these undisputed facts, there is every reason to conclude that the balance between the returns earned by publishers and songwriters and the incomes earned by record companies has gotten out of whack, requiring a reduction in the mechanical rate.

374. In 1981, when the situation was precisely the opposite, with record company profits and revenues shooting up while publishers and songwriters were not keeping up, the CRT ruled that this provided a basis for a substantial increase in the mechanical rate. The statutory standards should work both ways. RIAA PFF ¶¶ 1453-57. The Copyright Owners do not rebut that times have changed in this way since 1981—indeed, they seem to make this very point in their own proposed findings. CO PFF ¶¶ 665-666 ("The recorded music market has fundamentally changed since the CRT's decision in 1981.").

375. Generally, the balance between copyright owner returns and copyright user income is maintained by the application of market forces. And there is direct evidence here that the parties before the Court are routinely entering into voluntary agreements specifying mechanical rates well below the current 9.1 cents per track. Wildman WRT at 37-38, RIAA Trial Ex. 87. Those agreements speak volumes about what level of royalty provides both a fair return to the Copyright Owners and a fair income to the record companies.

376. Certainly the fact that the publishers and songwriters are continuing to prosper, even though the average effective mechanical rate is at least two cents lower than the statutory

rate, Wildman WRT at 37-38, RIAA Trial Ex. 87, should allay any concern that lowering the statutory rate will unduly harm the interests and returns of the Copyright Owners.

377. Indeed, such a reduction may ultimately benefit all concerned. It should not be assumed that "returns to the copyright owner and income to the copyright user are necessarily inversely related." Teece WDT at 87, RIAA Trial Ex. 64. Because the returns of the publishers and songwriters depend on the ability of record companies to make and sell recordings, one would expect "the highest returns to the copyright owner to occur where the copyright users (the record company) are also earning a 'fair income.'" Teece WDT at 87, RIAA Trial Ex. 64.

C. Third Objective -- Relative Contributions to the Product Made Available to the Public

378. The evidence makes clear that when it comes to contributions, investments and risks—the considerations included in the third statutory factor—the record companies lead the way. The Copyright Owners love to quote the NSAI's motto, "It all begins with a song." *See* CO PFF ¶¶ 216, 765. They ignore that after the song is written, the contributions of the songwriter and music publisher end. Even though an almost innumerable number of steps remain in order for a song to develop into a successful sound recording that the public will buy, it is the record company, not the songwriter or music publisher, that makes the critical contribution at each of those steps (and, in fact, the record company increasingly plays a role in writing the songs as well, *see* RIAA PFF ¶¶ 1278-1284). For the rest of the process of creating a sound recording, marketing it, manufacturing it and distributing it, the songwriter and music publisher sit on the sidelines, collecting checks from the first sound recording sold, while the record company continues to invest, whether the record is successful or not.

379. Indeed, it was not really disputed at trial that the contributions, investments and risk of record companies dwarf those of the Copyright Owners. RIAA PFF ¶ 1319. Nor do the

Copyright Owners offer any meaningful evidence rebutting RIAA's proposed factual findings. It follows that if any adjustment off of benchmark rates is made to take this statutory factor into account, it should be an adjustment downward.

1. Creative Contribution

380. As discussed in RIAA's Proposed Findings of Fact, there are various creative contributions in the chain of events that go from the writing of a song to the sale of a recording. RIAA PFF ¶¶ 1274-1285. While it is difficult to value creative contributions in the abstract, to the extent that one looks at market valuation, it is clear that the rare and therefore more valuable contributions are those made after a song is written, when the record company A&R department works to turn it into a successful recording. Songs are more than plentiful. But the resources and talent needed to make compositions into high-quality and marketable recordings are in very short supply. RIAA PFF ¶¶ 1275-1277.

381. If one compares the creative contributions of the record companies and the publishers, the competition is not even close. When they attempt to show that publishers contribute creatively, most of what the Copyright Owners come up with is financial support that they provide to songwriters in the form of advances, plus the publishers' supposedly large contributions in terms of promoting songs once written. CO PFF Section V.B. But to treat advances as a creative contribution rather than a capital investment is to engage in double-counting. Moreover, the larger advances nearly always go to successful singer-songwriters who are already under contract with record companies, thus minimizing any risk to the publisher. RIAA PFF ¶ 466. And as RIAA has shown, the publishers regularly recoup 90% of their advances—proving that they are mostly making "safe" bets in established singer-songwriters rather than taking risks on unproven writers. RIAA RPFF Section IV.C.2.

382. The Copyright Owners point to the A&R departments of the publishers. CO PFF ¶¶ 15, 296-300. But they are tiny by comparison to the A&R departments of record companies. RIAA PFF ¶ 1315. Moreover, their primary function is to scour the country to look for new songwriters to sign, rather than participating in the creative process. CO PFF ¶¶ 296-297. That does not compare, in terms of creative contribution, with the record companies' core function of matching songs, producers, artists, back-up musicians, etc. to produce creative works that the public will enjoy and want to purchase.

383. Moreover, even this talent scouting function is grossly exaggerated, because in many if not most instances, publishers establish relationships with songwriters after they already are under contract with record companies. RIAA PFF ¶¶ 464, 1281. Mr. Firth said that of 42 new songwriters signed by BMG in 2005, 27 had not yet released a commercial record. CO PFF ¶ 295. He did not say how many already had record company contracts—and indeed, it is likely that many did.

384. The music publishers' exaggeration of their talent scouting function is exemplified by the difficulty the Copyright Owners have had throughout this proceeding in coming up with examples of successful singer-songwriters that they have actually discovered. Their most prominent name was Alicia Keys, but that example imploded on them when RIAA showed that she had actually been signed by a record company first, and that her publisher only learned of her through an introduction arranged by the label. RIAA RPFF Section IV.C.2. The next most prominent example was James Blunt, but as RIAA showed, his success depending on a multimillion-dollar marketing campaign by his record company that even his publisher conceded was "brilliant." RIAA PFF ¶ 458. Other examples advanced by the Copyright Owners related to songwriters who were commercially unsuccessful (Lance Miller), or had already

achieved financial backing and recorded most of the songs on their first album prior to signing a publishing deal (Linda Perry), or simply dated from the 1950's (Buddy Holly). RIAA RPFF Section IV.C.2.

385. The Copyright Owners did present some evidence that publishers have creative professionals who work with songwriters and suggest collaborations. CO PFF ¶¶ 317-322. But it is hard to see these efforts as particularly significant given the tiny amounts of money that are devoted to them, as compared to the A&R functions of record companies. RIAA PFF ¶¶ 1316-1318.

386. Indeed, the industry has evolved to the point where much of the songwriting occurs in a record company's recording studio, facilitated by producers paid by the record companies. RIAA PFF ¶ 1282. Thus, record companies are now contributing to the actual creation of musical compositions, in many cases as much or more than the publishers who will be told about the compositions after the recordings are made. RIAA PFF ¶ 1283.

387. The publishers' role in matching songs with artists has thus been greatly reduced, particularly outside Nashville, where pure songwriters and song pluggers do continue to exist. RIAA PFF ¶ 1279. The Copyright Owners claim that publishers continue to "promote" songs and songwriters in all genres, CO PFF ¶¶ 327-328, 783, but their expenditures for this function are extremely small, both in absolute terms and as a percentage of their revenues and profits. RIAA PFF ¶¶ 449-453. Moreover, the Copyright Owners provide only anecdotal support for this claim, for example, by discussing how many meetings an individual song-plugger might have a week, without saying how many such employees there are or whether they have other job functions as well. CO PFF ¶¶ 327-328.

388. The relative lack of creative contribution of publishers in the age of the singer-songwriter is reflected in the typical split of royalties between publishers and songwriters, which has gone from 50-50 to 75-25, precisely because songwriters no longer need or receive that kind of assistance. RIAA PFF ¶ 1284.

389. Remarkably, the Copyright Owners, in seeking to conjure up reasons why they deserve relatively more compensation in the form of mechanical royalties, even see fit to emphasize their efforts to promote songs for use in movies and television shows. CO PFF ¶¶ 18, 329, 331. They continue to argue that synchronization (and performance) *revenues* of publishers and songwriters are not relevant with regard to any of the four statutory factors, CO PFF ¶ 786, even as they argue that the much-less-significant performance and synchronization revenues of record companies *are* relevant because they increase their ability to pay higher mechanical royalties, CO PFF ¶ 420. *See also* CO PFF ¶ 336 (describing publishers' efforts to sell sheet music and song lyrics online, for which non-mechanical royalties are paid).

390. In addition, the Copyright Owners talk repeatedly about the publishers' important work on behalf of songwriters in terms of registering and administering copyrights. CO PFF ¶¶ 18, 287, 333-35, 338-40. These services may be important to songwriters, and may be relevant to the division of royalties between songwriters and publishers, but they hardly constitute a factor supporting heightened royalty payments by the record companies to the Copyright Owners. Moreover, the amount they spend on this activity is minimal. RIAA RPFF Section IV.C.2. This work is simply irrelevant as a matter of common sense and under the four statutory factors.

2. Technological Contributions and Opening New Markets

391. When it comes to technological contributions, as discussed in RIAA PFF Section V.C.5, the record companies have made massive investments in the development and implementation of new technologies for delivery of recorded music to consumers. None of that is really disputed.

392. The Copyright Owners claim that the record is devoid of evidence establishing the amount of the investment in digital infrastructure, as part of their fruitless effort to claim that distribution costs are disappearing in the digital age. CO PFF ¶ 751. But they ignore the very specific financial figures provided in the testimony, *see* RIAA PFF ¶¶ 1351-1353, as well as the extensive testimony detailing the types of systems and products that have had to be developed, RIAA PFF ¶¶ 1354-1383; RIAA RPFF Section IV.B.4.b. Given this evidence, it is grossly inaccurate for the Copyright Owners to claim that the record demonstrates that the record companies' costs in developing the digital marketplace have been "minimal," amounting to only a few thousand dollars a year. CO PFF ¶ 752.

393. By contrast, the Copyright Owners *make no claim to have made any technological contribution whatsoever. See* RIAA PFF ¶ 1387 (citing publisher testimony that their function is no different in the digital world than in the world of CDs and cassettes). To be sure, they take credit for having "played a critical role" in the development of ringtones as a new product. CO PFF ¶ 29; *see* CO PFF ¶ 337 ("Music publishers were also integral to the creation of the ringtone market . . . ."). But closer examination reveals that the critical contribution consisted entirely of being willing to license their compositions to be used in ringtones sold by others, during a period when the publishers erroneously took the position that this use of musical

compositions is not covered by the Section 115 compulsory license. CO PFF ¶¶ 29, 337. That hardly counts as a technological contribution.

394. With regard to anti-piracy efforts, RIAA documented that the efforts and expenditures of the recording industry have been many times greater than those of the music publishing industry. RIAA PFF ¶¶ 1391-1414. The best that the Copyright Owners can do in response is to point to vague statements about the NMPA serving as a "lead" party in several cases against companies operating illegal file-sharing operations, CO PFF ¶¶ 102, 799-800—a status that says little or nothing about the degree of financial or other forms of participation (which has been minimal compared to the record companies and RIAA). The record is unambiguous that the publishers have played no role in the fight against physical piracy—*i.e.*, unauthorized duplication of CDs. RIAA PFF ¶ 1414.

3. Capital Investment, Cost and Risk

395. RIAA has already laid out in detail the evidence showing that the investments and expenditures made by record companies, and the risks associated therewith, dwarf the investments, expenditures and risks of the music publishers and songwriters. RIAA PFF ¶¶ 1285-1347. This evidence could hardly be rebutted and it has not been.

396. Nor has the importance of record companies' contributions become diminished as digital opportunities have grown which allow people to showcase their music independently. As the March 2007 Enders Analysis report explained, even in light of the "explosion in self-publishing" and the "excitement around the 'internet discovery'" of bands, record companies' contributions are still necessary because it "remains extremely difficult for independently produced recordings to succeed." RIAA Trial Ex. 27 at 15. As the Enders Analysis noted, "'of the approximately 32,000 new CDs released worldwide each year, only 250 sell more than

10,000 copies, and fewer than 30 go platinum . . . only 3% of albums ever sell more than 5,000 copies.'" RIAA Trial Ex. 27 at 15 (quoting Kusek and Leonhard, The Future of Music (2005), p. 108).

397. The record companies are essential because they provide services that are integral to the success of artists and that are not otherwise available in the marketplace: "Generally, only the labels can create the excitement and success of these few winners, pay advances to artists to enable them to work creatively and tour, and concoct the promotional campaigns that help create the buzz." RIAA Trial Ex. 27 at 15. In short, even in today's changing marketplace, it is record companies whose contributions are the key to commercial success.

398. With regard to music publishers, the best that the Copyright Owners can do is to throw around various figures from the books of individual publishers about what they spend on various functions, without any effort to compare those figures to comparable expenditures and investments of record companies. *E.g.*, CO PFF ¶ 781. In fact, as RIAA has amply explained, the record companies' expenditures are far, far greater. RIAA RPFF Section IV.C.2.

399. With regard to risks incurred by music publishers, the Copyright Owners simply ignore the numerous documents in the record in which music publishers told investors and the world that they operate low-risk, annuity-like businesses. RIAA PFF ¶¶ 357, 439, 1232. The best response they can come up with is to refer to songwriter advances and claim that a large percentage of those advances are never recouped. CO PFF ¶¶ 316, 766, 781. But that claim, made by both Mr. Firth and Mr. Faxon, is simply false. RIAA PFF ¶¶ 475, 479. In fact, as the books and records of the publishers make clear, evaluating advances and recoupments on a year by year basis makes clear that publishers regularly recoup 90 percent of what they spend on

advances—far greater than the 45-70 percent recouped by the record companies. RIAA PFF Sections II.E.4.d.iii & II.E.2.

400. As for the songwriters, the Copyright Owners do not and cannot claim that they make financial contributions to the production of sound recordings of any significance. Indeed, they fail to identify the specific costs they claim are associated with songwriting, other than living expenses.

401. The Copyright Owners nevertheless claim that songwriters incur substantial risks. But that is a misleading exercise. There is no disputing that an aspiring songwriter has a low probability of earning a substantial living from songwriting. Just as Los Angeles is filled with aspiring actors earning their living as waiters and waitresses while hoping to be the next Tom Cruise or Angelina Jolie, the music industry is filled with persons of wildly varying talents and skills who aspire to make millions by writing hit songs but who will never do so. Just as there are far more aspiring actors than there are lead roles in hit films, there are far more songs being written than there are spots on an album (especially as album sales and prices decline and record companies have been forced to cut back on the number of albums released and the number of tracks per album, *see* RIAA PFF ¶¶ 180, 204, 207, 208, 251, 1118, 1123, 1125, 1141, & 1553). Yet just because there is a low probability of making millions of dollars as a songwriter does not mean that songwriters face significant "risk" in the process of making sound recordings available to the public.

402. In fact, the only "risk" taken by the songwriter is the songwriter's time spent writing that might otherwise have been spent earning a living by other means. 5/13/08 Tr. 6005:7-21 (Wildman). For example, there was no evidence presented that songwriters have substantial capital at risk in writing a song. To the contrary, the evidence demonstrated that even

if a songwriter never writes a hit, the songwriter nevertheless gets to keep his or her entire advance. These advances, which the Copyright Owners describe as "substantial," CO PFF ¶ 308, minimize any "risk" taken by a songwriter in setting aside the time to write songs because the advance represents a guaranteed stream of income regardless whether the songs end up selling. And the "risk" taken by the music publisher in providing writers with advances is minimized by the fact that music publishers do not normally provide these advances to writers unless a record company has already agreed to invest a large multiple of that amount in the writer in his or her capacity as a performer. RIAA PFF ¶ 464. The only party truly exposed to great risk, then, is the record company.

403. Professor Landes completely omitted songwriter advances from his analysis of the "riskiness" of songwriting, which is repeated in CO PFF ¶ 793. *See* 5/20/08 Tr. 7329:16-7330:2 (Landes) (acknowledging that he failed to report songwriter advances in his study of songwriter income). Because advances are one of the basic means by which songwriters mitigate risk, Professor Landes's analysis is completely meaningless and should be disregarded in its entirety.

404. The ultimate fact proving that the record companies' risk is several orders of magnitude larger is this: everything that the Copyright Owners describe in their Proposed Findings of Fact as a "risk" taken by the songwriter is actually a cost borne *exclusively by the record company*. The Copyright Owners write: "As Mr. Galdston best summarized it: 'in writing a song, there is a risk that it will not be recorded by an artist or licensed by a record label. Even if the song is recorded, it may not be released. If it is released, it may not be successful.'" CO PFF ¶ 227 (quoting Galdston WDT at 4-5, CO Trial Ex. 4). Yet it is the record company that bears the cost of recording the album. It is the record company that bears the cost of manufacturing the album. It is the record company that bears the cost of releasing the album.

And it is the record company that bears the cost of promoting the album in order to ensure its success. Once Mr. Galdston has written his song, the only "risk" he faces is whether a record company is capable and willing to put forth the very substantial funds and effort to make the record a success. And Mr. Galdston receives royalties from the very first record sold, while the costs borne by the record company may take years to be recovered, if they are recovered at all.

D. Fourth Objective -- Disruption

405. The Copyright Owners say little in their proposed findings about the fourth statutory factor—avoiding disruption—except with regard to the choice between a penny rate and a percentage rate. That is remarkable given the strong evidence that even a rate much lower than they propose—*i.e.*, the current 9.1 cents rate—is already causing substantial disruption. RIAA PFF ¶¶ 1441-1445. The disruption factor thus points strongly toward the need for a significant rate reduction, regardless of whether that reduction takes the form of a cents rate or a percentage rate.

406. Certainly it should be clear that any increase in the rate would be disruptive. RIAA PFF ¶¶ 1446-1452. The rate has already been substantially increased during a period when the price of recordings, the unit sales of recordings, and the resulting revenues of record companies out of which mechanical royalties are paid have all been dropping sharply. Even the Copyright Owners recognize that these events have been greatly disruptive of the recording industry. CO PFF ¶ 665 ("As Professor Teece himself observed, 'the recording industry is in the midst of a significant and sustained disruption of its "structure" and "industry practices."'") The Copyright Owners did not cause these phenomena, but the fourth statutory factor, much like the second (fair return/fair income), counsels strongly against ignoring the quite disparate economic circumstances of the parties before this Court.

407. The Copyright Owners protest that record company profitability is on the rise and that mechanical royalties are a small fraction of record companies' overall expense, CO COL ¶ 98, but the facts in the record amply dispute that. As RIAA has shown, Bruce Benson's testimony demonstrates exactly the opposite: that record company margins, far from growing, are currently shrinking. RIAA RPFF Section IV.B.3.a. As for mechanical royalties, RIAA has shown beyond any question that mechanical royalties are the one expense that record companies have been unable to control. In fact, *all* of the record companies' expenses, including artist royalties, have declined in absolute terms since 1999. Mechanical royalties, by contrast, continue to climb upward. RIAA RPFF Section IV.B.2.

408. The Copyright Owners also suggest that the record companies are unable to show that higher mechanical royalties would reduce A&R spending, CO COL ¶ 99, but that is both untrue and irrelevant. RIAA RPFF Section IV.B.6. It is untrue because, in fact, trends in record company revenues and expenditures over the last two decades show conclusively that A&R spending has risen when the financial situation of the record companies has improved, and fallen when the financial situation deteriorates. CO Trial Ex. 41 at RIAA_0008423. Indeed, as RIAA has shown, as the mechanical royalty rate has squeezed margins more and more over the last decade, record companies have had to cut artists rosters to the bone. RIAA PFF Section II.E.1.c.ii. And it is irrelevant because whether the funds to pay for the Copyright Owners' massive proposed increase comes from A&R or marketing or some other record company activity, it will still undercut activities that benefit record companies, music publishers, songwriters and music consumers alike.

409. With regard to the choice between a percentage and a cents rate, the Copyright Owners primarily emphasize that a cents rate has been around for nearly 100 years. CO PFF

¶ 644. But this reliance on history becomes somewhat ironic when, just a few paragraphs later, they reject any reliance on the 1981 CRT decision as a benchmark, on the theory that the recording industry and marketplace went through transformational change beginning in 2000 and are now "fundamentally different" from the past. CO PFF ¶¶ 665-666.

410. They cannot have it both ways. Those transformational changes are precisely the reason why a percentage rate is much more needed now than in the past. We are now witnessing a series of new and unforeseen products and services being introduced into the market on a regular basis. This kind of innovation depends on the flexibility that a percentage rate provides. RIAA PFF ¶¶ 1511-1552. Moreover, in the current economic circumstances, the record companies, faced with stiff competition from illegal file sharing and elsewhere, now need pricing flexibility even for conventional products like CDs, in order to produce the optimal sales outcomes that will benefit both Copyright Owners and Copyright Users alike. RIAA PFF ¶¶ 1553-1567.

411. The Copyright Owners rely on Roger Faxon's testimony that a percentage rate, or a substantially reduced penny rate, would require renegotiation of hundreds of contracts between EMI MP and songwriters. CO PFF ¶¶ 645-646. But they ignore the fact that this is a problem that EMI MP brought on itself solely as a result of its desire to protect itself, at the expense of the songwriters, from the effects of any decrease in the mechanical royalty rate. That was the only reason that they chose to specify a particular minimum amount of royalties that EMI MP was entitled to collect on each singer-songwriter's album, instead of just specifying a minimum number of tracks on which EMI MP could collect royalties per album. RIAA PFF ¶ 1497.

412. The problem is particularly self-inflicted since EMI MP continued to enter into contracts with this feature long after RIAA in 2006 proposed mechanical rates using a percentage

rate structure. The Copyright Owners are entitled, in operating their businesses, to bet that RIAA will not prevail in this case, but they are not entitled to use such deliberate wagers as justifications for failing to adopt an otherwise efficient and desirable rate proposal. RIAA PFF ¶ 1498.

413. In any event, the problem is easily fixed, and RIAA has proposed a transition period that would allow it to be fixed. EMI MP need only agree to look only at its average per-track percentage-based royalty or to enforce the minimum-track requirement in its contracts without enforcing the minimum royalty requirement. RIAA PFF ¶ 1499.

414. Finally, if the Court decides to mandate a cents rate, there would be no conflict with the EMI MP contracts (or at least with the contract offered as a "typical" exemplar of those provisions, 5/14/08 Tr. 6556:21 (Faxon)) unless the rate were set at [ ] per track or lower. At that level or above, the songwriter would be able to produce a sufficient amount of royalty revenue for EMI MP, consistent with the limitations imposed by the controlled composition agreement with the record company. RIAA PFF ¶ 1500.

415. The Copyright Owners' only other argument about disruption is the claim that a switch to a percentage rate would make audits of mechanical royalty payments more complex. CO PFF ¶ 648 (citing Pedecine WRT at 14-15 (CO Trial Ex. 394)). But in the cited testimony, Mr. Pedecine does not explain why it would be significantly more difficult to audit record company records of wholesale receipts for recordings sold, as opposed to record company records of the number of units sold. That is far from intuitively obvious. Certainly voluntary deals specifying that payments will be based on a percentage of revenue are extremely common in the recording industry and seem to cause no undue disruption. RIAA PFF ¶ 1490.

E. Even If the Court Adopts the Ringtone Benchmark Proffered by the Copyright Owners, the Four Statutory Factors Compel a Significant Reduction Below that Rate.

416. If the Court adopts RIAA's proposed benchmarks, it need do nothing to adjust the rates and terms to satisfy the four statutory factors. If the Court concludes that the ringtone benchmark (or one of the Copyright Owners' other benchmarks) is the most appropriate starting point for setting rates and terms in this proceeding, it must nonetheless make significant downward adjustments to that benchmark in order to satisfy the four statutory factors and Congress' direction that the Court set a reasonable rate in this proceeding.

417. As this Court has made clear, the four statutory factors are not a "beauty pageant." *SDARS Decision*, 73 Fed. Reg. at 4094. The factors may, however, compel a modification of a benchmark rate, especially where there are important differences between the target market and the market selected as a benchmark. *SDARS Decision*, 73 Fed. Reg. at 4091.

418. As discussed above, each of the four statutory factors, viewed on its own, compels a reduction from the current rate. The statutory factors, however, compel an even greater departure if the starting point is one of the Copyright Owners' benchmarks, such as the ringtone benchmark. That is because of the vast differences between the Copyright Owners' primary benchmark market (ringtones) and the target market for CDs and digital downloads.

419. As discussed in RIAA PFF Section V.A.7, the market already gives the Court a clear measure of the types of compensation needed to incentivize songwriters to write new works and the types of royalty rates that are sufficiently reasonable to ensure that record companies create sound recordings embodying musical works to be distributed to the public. These are the rates actually negotiated in the marketplace and reviewed by Dr. Wildman. The ringtone rates proffered by the Copyright Owners bear no resemblance to those rates and a substantial

downward departure is required to adjust the ringtone rates for application in the market for CDs and digital downloads.

420. For the same reasons, the second statutory factor compels a reduction in the rate to bring the elevated ringtone rates in line with the notions of a fair income and fair return that are shown by marketplace transactions for CDs and digital downloads. RIAA PFF Section V.B.3. Similarly, as the D.C. Circuit has recognized, international rates provide a measure of a fair return to copyright owners, and those rates also compel a significant reduction off the ringtone benchmark. *Recording Industry Ass'n of America v. CRT*, 662 F.2d 1, 10 n.23 (D.C. Cir. 1981). Finally, as Mr. Benson's testimony and Dr. Wildman's analysis shows, the surpluses generated by ringtones (which are highly profitable) and CDs and digital downloads (which are far less profitable) are so different that it makes little sense to translate one in the simple manner that Dr. Landes does. RIAA PFF Section IV.D.8.

421. The third statutory factor reflects the relative contribution and risk faced by the parties, and the record amply reflects not only that the costs incurred by record companies far outstrip those of Copyright Owners, but that the risks facing record companies before they create an individual sound recording and have invested in the A&R, marketing, manufacturing, and distribution expenses, are altogether different from and greater than those that they faced when negotiating the NDMAs, on which the Copyright Owners rely. In contrast, the risks faced by music publishers were far greater when they were negotiating the NDMAs because they had something to lose—their mono and polyphonic ringtone revenues; by comparison, in negotiating mechanical licenses in an effort to persuade a record company to invest in a sound recording, even Dr. Landes and Mr. Faxon recognize that songwriters and musical publishers have little to

lose. RIAA PFF Section V.C.6; 2/11/08 Tr. 2387:15-2388:6 (Landes); 5/14/08 Tr. 6414:18-21 (Faxon).

422. Finally, as detailed by the testimony of Mr. Benson, record companies are already facing very difficult times currently and a bleak future with continuing declines in revenues and continued restructurings in the offing. An increased mechanical royalty rate would cause even greater problems; as RIAA has shown, a rate such as that proposed by the Copyright Owners based on the ringtone benchmark would wipe out the slim profits that record companies are able to eke out currently. RIAA PFF Section V.A.2. If the Court were to adopt the ringtone benchmark as a starting point, it must then significantly reduce that rate to satisfy the fourth statutory factor. RIAA PFF Section V.D.

VI. THE COURT SHOULD REJECT THE TESTIMONY OF THE WITNESSES PROFERRED AS EXPERTS BY THE COPYRIGHT OWNERS.

423. The Copyright Owners proffered four witnesses as experts, and those witnesses play integral roles in the Copyright Owners Proposed Findings of Fact. For the reasons discussed below, their testimony lacks credibility in several respects and should in large part be rejected.

A. Helen Murphy

424. As set forth in RIAA's findings of fact, Helen Murphy thoroughly discredited herself as a witness in this proceeding. This Court has already recognized the fundamental flaws in her testimony. This Court issued an Order disqualifying Ms. Murphy as an expert and striking portions of her testimony, found that portions of her written and oral testimony were "inaccurate and misleading," and found that she "made a number of errors in analyzing and assembling the facts and data in her amended written direct statement." *See* RIAA PFF ¶¶ 305-307.

425. Given the Court's repudiation of Ms. Murphy in the direct case phase of the proceeding, one expected that the Copyright Owners would present a new witness with more accurate and reliable testimony and data in the rebuttal case phase to discuss the financial condition of record companies. But the Copyright Owners did not do so. Instead, they chose to stand by Ms. Murphy and to rely on her testimony in their findings of fact for key allegations about record companies.

426. In fact, examination of the Copyright Owners' findings of fact discloses that some of the most dubious claims in their findings are supported by citations to Ms. Murphy's testimony. For example, she is the source of their allegations that record companies are in a "healthy financial state," CO PFF ¶ 355; that record companies' margins and profits have "increased," ¶ 398; and that record companies' profitability has "increased to record highs." ¶ 417. In addition, the Copyright Owners' findings of fact rely on Ms. Murphy for data on record companies and for calculating record companies' purported profit margins. *See, e.g.*, CO PFF ¶¶ 401, 439. The Copyright Owners offer no explanation as to why these claims should be deemed any more trustworthy than the rest of her unreliable testimony. To the contrary, as demonstrated at length by RIAA Proposed Findings of Fact, Ms. Murphy's claims are fundamentally inconsistent with the overwhelming weight of evidence about the financial condition of record companies. *See* RIAA PFF Section II.E.1.

427. For all of the reasons discussed in RIAA's Proposed Findings of Fact and previously identified by this Court, this Court should disregard Ms. Murphy's testimony when reaching its determination in this proceeding. RIAA PFF ¶¶ 305-307.

B. Claire Enders

428. Ms. Enders has testified once before, as an expert witness in the U.K. Copyright Tribunal in the recent proceeding involving online rates in the U.K. 2/4/08 Tr. 1134:11-19 (Enders). In that proceeding, the Judges found that Ms. Enders' testimony was "uninspiring." They concluded that "on a number of key issues she seemed confused, occasionally inaccurate and, more importantly, sometimes unable to provide reasons for the assumptions upon which her evidence was based." The Judges, in short, found that they "were not greatly assisted" by her testimony. RIAA Trial Ex. 55 at 37.

429. Notwithstanding that judicial evaluation, the Copyright Owners feature the testimony of Ms. Enders prominently in their findings of fact to support their positions on the past, current and projected financial condition of the digital market for music, including record company revenues and consumers' alleged preference for downloads over other formats, among other things. *See, e.g.*, CO PFF Sections VII.B-E, VIII.B, X.A-C, XI.

430. Indeed, the Copyright Owners cite Ms. Enders' testimony more than 140 times in their findings of fact. But one thing is conspicuously absent from the Copyright Owners' findings – any reference to or citation of the March 2007 Enders Analysis report on "Recorded Music and Music Publishing." That document, which was admitted into evidence as RIAA Trial Ex. 27, is the most recent version of the independent research report that Ms. Enders prepares in the ordinary course of business for her consulting clients. *See* 2/4/08 Tr. 1123:12-19, 1280:8-20 (Enders).

431. Unlike Ms. Enders' testimony prepared for this litigation that the Copyright Owners cite so freely in their findings of fact, the March 2007 Enders Analysis report reflects Ms. Enders' views on the digital market that have not been tailored to fit the Copyright Owners'

litigation needs. As such, it presents a more unbiased opinion about the digital music market. A comparison of her testimony in this proceeding to the March 2007 Enders Analysis report makes clear that Ms. Enders' testimony is not reliable—while Ms. Enders has provided testimony to this Court about the digital music market that conveniently suits the Copyright Owners' litigation strategy, she said something very different to her consulting clients in the March 2007 Enders Analysis report.

432. For example, in their findings of fact, the Copyright Owners cite Ms. Enders in support of their claims that "the futures of the record companies and the online providers of permanent downloads are bright" and that the "digital market [will] grow rapidly." CO PFF ¶ 40. But the evidence shows that Ms. Enders believes the precise opposite to be true. In the March 2007 Enders Analysis report, she stated that the growth rate for downloads will "decline," that the music industry "has pinned its hopes for top line recovery on sales of digital downloads, but we believe this faith is misplaced," that "[s]trong digital sales are far from the solution to the industry's ills," that "the music industry should abandon hope that legitimate online sales of catalogue will create significant incremental income for them, or that there is significant untapped demand for it online," and that revenue growth for mobile music "will fall to zero" by 2010. *See* RIAA PFF ¶ 309 (quoting RIAA Trial Ex. 27 at 2, 5, 9, 20, 22 (Enders Analysis report)).

433. Similarly, the Copyright Owners cite Ms. Enders' testimony to support their claim that consumers prefer and value downloads more than physical formats. CO PFF Section VII.D.4. Once again, Ms. Enders' testimony in this case contradicts statements she made in the Enders Analysis March 2007 report prepared for her clients in the ordinary course of business. In that report, Ms. Enders stated that consumers value downloads *less* than physical products:

"Compared to physical format, consumers tend to attribute a lower value to the single track or album download." RIAA Trial Ex. 27 at 14 (Ender Analysis).

434. This pattern of testimony that contradicts her own recent out-of-court statements strongly suggests that Ms. Enders' testimony is biased and unreliable. Even under the most charitable interpretation that Ms. Enders was, in the words of the U.K. Tribunal, merely "confused," the inconsistencies cast doubt on everything she told this Court. In light of the foregoing, this Court should not credit Ms. Enders' testimony or the Copyright Owners' findings and conclusions that rely on her testimony.

435. To be clear, RIAA is not suggesting that the March 2007 Enders Analysis report, prepared in the ordinary course of business, is unreliable—but as noted above, the Copyright Owners make no reference to that document in their findings of fact.

C. William Landes

436. The serious theoretical problems with each of Professor Landes's benchmarks have been discussed at length already. *See* RIAA PFF Section IV. It bears repeating that the "range of reasonableness" advocated by Professor Landes is so wide that his testimony supports any rate between 20% and 50% of the total content costs, a proposition that makes no economic sense given that his range of reasonableness is supposed to approximate the actual market value of a musical work. As Professor Wildman put it, "Would we accept both $2 and $5 as plausible benchmarks for the price a competitive market would set for a half-gallon of milk? . . . Would we accept $15,000 and $37,500 as plausible lower and upper bounds for prices that would be both fair to consumers and provide reasonable compensation to auto manufacturers and dealers? . . . The notion that any rate within such an extremely broad range might reasonably approximate a market-defined rate lacks facial credibility and reflects the fact that Professor Landes's selection

of proposed benchmarks was not guided by reference to a set of criteria that would ensure reasonable comparability." Wildman WRT at 9-10, RIAA Trial Ex. 87.

437. Independent of the economic shortcomings of Professor Landes's benchmark analysis, it became quite evident during the course of this proceeding that Professor Landes's empirical work was repeatedly marred by serious methodological, technological, and theoretical flaws.

438. With respect to Professor Landes's analysis of HFA licensing data, the many systemic flaws in his analysis were outlined in detail in the written rebuttal testimony of David Alfaro and in RIAA's Proposed Findings of Fact. *See* RIAA PFF Section IV.F.2. In their Proposed Findings of Fact, the Copyright Owners argue that Mr. Alfaro incorrectly claimed that the exclusion of licenses issued under controlled composition clauses altered the results of Professor Landes's study. *See* CO PFF ¶ 577. That defense of Professor Landes contradicts what Professor Landes himself said. Professor Landes himself admitted that the inclusion of controlled licenses changed the results of his study because the inclusion of these controlled licenses resulted in an *increase* in the amount of discounting below the statutory rate from 2003 onward. *See* 5/20/08 Tr. 7390:21-7391:7 (Landes).

439. The Copyright Owners attempt in their Proposed Findings of Fact to rehabilitate a separate methodological flaw in Professor Landes's HFA study—his misclassification of physical licenses as digital and vice versa. They admit, as they must, that he misclassified licenses: "certain digital configurations were classified as 'physical' in an interim step in his analysis." CO PFF ¶ 579. But they defend Professor Landes by claiming that some (but not all) of these licenses were later excluded in another step of the analysis (which, at trial, Professor Landes admitted was not actually conducted by him, but rather by an unnamed "programmer,"

see 5/20/08 Tr. 7399:11-22 (Landes)). Importantly, Professor Landes does not deny misclassifying the licenses to begin with, and he further does not deny that the digital licenses misclassified as physical which *had* rates listed in HFA's database continued to be misclassified throughout his analysis. Accordingly, it is undisputed that Professor Landes misclassified digital licenses as physical and that those digital licenses with rates listed in HFA's database continued to be misclassified throughout Professor Landes's study.

440. With regard to the most critical errors in Professor Landes's testimony that Mr. Alfaro identified, the Copyright Owners try to deflect the issue by lobbing an unfounded accusation at Mr. Alfaro. Specifically, they assert in their Proposed Findings of Fact that Mr. Alfaro "was forced to withdraw" additional complaints about Professor Landes's work. *See* CO PFF ¶ 580. That claim is false. The Copyright Owners did not object to the admission of Mr. Alfaro's testimony at trial, and no portion of his testimony was stricken or withdrawn.

441. All that occurred was that Mr. Alfaro submitted corrected testimony changing some of his specific results after it was revealed that the Copyright Owners had produced to him incorrect information about the formatting of the HFA database. RIAA PFF ¶¶ 1050-1057. Dr. Landes's testimony in evidence, by contrast, continues to be marred by errors caused by the same incorrect formatting information. RIAA PFF ¶¶ 1054-1057.

442. The false allegation that Mr. Alfaro was "forced to withdraw" criticisms of Professor Landes merely represents an attempt by the Copyright Owners to hide the fact that *they have no answer* to Mr. Alfaro's most targeted criticisms of Professor Landes's HFA study—that his data was filled with substantial gaps, that his data was missing configuration codes for numerous licenses, and that he systematically excluded over 700,000 licenses with listed rates of "negotiated" or "reduced" in HFA's database (not to mention the fact that he conceded that the

HFA licensing pool is not representative of the overall industry, *see* 5/20/08 Tr. 7406:1-8 (Landes). The Copyright Owners, in fact, do not even attempt to defend these flaws in Professor Landes's HFA data analysis. Nor do they dispute Mr. Alfaro's findings that had Professor Landes actually included all the discounted licenses in the HFA database in his study, his results would have been substantially different. *See* RIAA PFF ¶¶ 1072-1078. They do not dispute these findings because they cannot. It is simply uncontestable that Professor Landes committed grave errors which affected the outcome of his analysis.

443. The Copyright Owners also incorrectly assert that the fact that Mr. Alfaro did not express an opinion about which licenses Professor Landes should or should not have excluded from his analysis somehow means that "Mr. Alfaro's testimony provides no basis for challenging any aspect of Professor Landes's work." *See* CO PFF ¶ 581. That is nonsense. Mr. Alfaro's testimony was not submitted for the purpose of expressing an opinion. Rather, Mr. Alfaro testified about the facts. The facts that he presented to the Court irrefutably establish a host of errors in Professor Landes's testimony. The fact that Professor Landes excluded over 700,000 discounted licenses from a study that purports to show trends in discounting over time is a devastating indictment of Professor Landes's testimony, and opinion testimony is not necessary to transform those facts into a challenge to Professor Landes. The facts alone are more than sufficient, and the Judges do not need Mr. Alfaro's opinion to reach that conclusion.

444. The flaws in Professor Landes's data analysis during this proceeding did not end with his HFA data analysis. As became quite evident during the rebuttal hearing, Professor Landes once again attempted to conduct data analysis—this time of UMPG songwriter royalty income—and once again bungled the attempt.

445. Professor Landes admitted that his songwriter study was marred by what he referred to at trial as "the truncation problem." 5/19/08 Tr. 7121:22-7122:1 (Landes). Essentially, Professor Landes extracted data from two different databases at UMPG without attempting to ensure that the set of songwriters and songs in each database was identical; he simply *assumed* that they were identical without bothering to check. 5/19/08 Tr. 7181:5-9 (Landes). As a result, he understated the income earned by songwriters in the last two years of his study, 2005 and 2006. 5/19/08 Tr. 7127:6-10 (Landes). Additionally, 700 songwriters were improperly excluded from his study altogether because of this truncation problem. 5/19/08 Tr. 7126:3-14 (Landes). Professor Landes was unaware of the problem with his songwriter study until RIAA moved to exclude the study due to these methodological errors. 5/19/08 Tr. 7181:15-7182:2 (Landes).

446. In sum, while the Court concluded that these errors did not justify striking the study from evidence in its entirety, the prevalence of these errors is yet another sign of Professor Landes's carelessness, his haphazard approach to data analysis, and ultimately his lack of credibility in this proceeding.

D. Kevin Murphy

447. As discussed above, the ultimate indictment of the Copyright Owners' case is that the testimony of their own expert, Kevin Murphy, actually supports a *decrease* in the statutory rate, not an increase. As explained above, if one accepts Professor Murphy's opinion that mechanical royalties should track the compensation paid for other creative inputs, a closer look at the evidence compels the conclusion that the current mechanical rate is too high because record company expenditures on other creative inputs (artist royalties and advances and recording costs) *actually declined substantially from 1999 to 2006*. *See* RIAA RPFF Section

II.E. In short, if Professor Murphy is correct that mechanical royalties should move in the same direction as other creative inputs, the record is clear that for the major record companies, mechanical payments are rising while expenditures for artist royalties and advances and recording are falling—precisely contrary to what Professor Murphy says should happen.

448. The muddled nature of Professor Murphy's testimony may stem from his lack of familiarity with the music industry. He has written only one paper involving the music business, has never testified before a court, legislative body or regulatory body in a case involving the music business, and conceded that music has never been the focus of his academic research. RIAA PFF ¶ 169. It is thus perhaps not surprising that his academic theorizing does not comport with the evidence.

449. In any event, it bears emphasizing that Professor Murphy—one of the Copyright Owners' two economic experts—testified that he was *not offering testimony supporting an increase in mechanical rate*. Rather, he explained that, at most, his testimony argued against a decrease in the mechanical rate. RIAA PFF ¶ 24. That is a critical and telling admission in a proceeding in which the Copyright Owners seek to not to maintain the status quo, but to increase the mechanical rate by 37% for physical products and 65% for downloads.

450. Finally, RIAA has already explained above in RIAA RPFF Section II.A.2 how Professor Murphy was misguided in his supposedly "empirical" study of controlled composition clauses. CO PFF ¶ 692. That study was nothing more than an unsound anecdotal review of a small and non-representative sample of agreements. As discussed above, that study was so small that it cannot reasonably form the basis of any conclusions about trends in controlled composition clauses.

VII. A PERCENTAGE OF REVENUE RATE STRUCTURE IS JUSTIFIED.

451. The Copyright Owners raise a series of objections to RIAA's proposed percentage of revenue rate structure. As discussed below, none of their arguments warrants retention of a cents rate, and these arguments are overwhelmed by the net benefits of a percentage of revenue rate structure. *See* RIAA PFF Section VI. As RIAA explained in its Proposed Findings of Fact, a percentage rate structure based on record company all-in wholesale revenues would most accurately reflect the value of music used, provide the necessary flexibility to enable new products and business models, and maximize the availability of creative works to the public. The United States should adopt a percentage rate structure just as virtually every other country in the world has already done. *See* RIAA PFF Section VI.F.

A. The Copyright Owners Incorrectly Claim That Unit-Based Rather Than Value-Based Mechanical Royalties Are Desirable.

452. The Copyright Owners hold up as a virtue of a cents rate that "the Copyright Owners are assured of the same compensation per use . . . regardless of how their works are used . . . ." CO PFF ¶ 593. They suggest that a percentage rate is undesirable because it is not tied to unit sales. CO PFF ¶ 593 (cents rate "ensures that mechanical royalties will increase proportionately with the unit sales of music"); CO COL ¶ 103 (cents rate more appropriate because usage based).

453. The Copyright Owners' argument is contrary to this Court's previous holdings that a rate should reflect the value of the music used. As in the webcasting proceeding, it sometimes may be possible to set a unit-based rate that is a good approximation of the value of the music used. However, it is the value, not the units, that are the key. RIAA RCOL Section IV.A. Here, as the Copyright Owners' own witnesses William Landes and Roger Faxon argue, the value of the music use varies depending on the context. RIAA RCOL Section IV.A; 1/29/08

Tr. 373:1-374:12 (Faxon). In such an environment, it is not a virtue but a vice of a cents rate that the Copyright Owners would receive the same compensation per use regardless of the value of the use.

B. The Copyright Owners Incorrectly Claim That the Interests of Copyright Owners and Copyright Users Are Not Aligned Under a Percentage of Revenue Rate Structure.

454. Relatedly, the Copyright Owners suggest that a cents rate is preferable to a percentage rate because a percentage rate does not align the interests of copyright owners and users. CO PFF ¶ 594. In one instance, the criticism is that under a percentage rate the parties' incentives are not "identical," CO PFF ¶ 607, in another it is that their interests are not "perfectly aligned," CO PFF ¶ 608. However, this is hardly an argument in favor of a cents rate. The Copyright Owners fail to explain how a cents rate would better align the parties' interests—certainly not identically or perfectly. Nor could they— under a cents rate structure, the Copyright Owners do not share in the benefits or risks of price variations, and they receive an inconsistent share of a record company's wholesale revenues for a CD, for example, depending on the number of tracks, pricing, retail outlet and other variables. *See* RIAA PFF ¶¶ 1574-1578.

455. The record clearly establishes that a percentage of revenue structure more closely aligns the parties' economic incentives. As discussed at length in RIAA's Proposed Findings of Fact, record companies set prices to maximize their revenues, and if record companies raise prices, a percentage of revenue rate structure ensures that copyright owners share in the upside. *See* RIAA PFF ¶¶ 1568-1580. And if record companies lower prices, they do so because they believe that a lower price will lead to higher unit sales and result in greater overall revenues. *See* RIAA PFF ¶ 1571.

C. RIAA's Proposed Definition of Revenue Is Not Complicated to Administer.

456. The Copyright Owners' claim in passing and with little explanation that a percentage of revenue rate structure is "more complex and may present measurement difficulties" does not withstand scrutiny. CO PFF ¶¶ 595-596. To be sure, the administration of mechanical licenses is complex, and the recorded music business has become more complex with a proliferation of products, business models and business partners. RIAA PFF Sections II.E.1.e.iv & V.C.5.d. But there is nothing that makes a percentage rate particularly complex or difficult to administer. Indeed, as discussed in RIAA PFF Section VI.G, record companies administer and pay virtually all their artist royalties based on a percentage of wholesale revenue similar to that which is proposed here.

457. In fact, as set forth in RIAA's Proposed Findings of Fact, administering RIAA's proposed rate would be straightforward: for all products except ringtones (and the settled configurations such as on-demand streaming) there would be a single percentage rate. For physical products, that percentage would be applied to gross sales as reflected on the applicable invoices, minus returns and sales discounts. For DPDs, the percentage would be applied to the payments to which a record company is entitled from a digital music service. RIAA PFF ¶¶ 1603-1605. *See generally* RIAA PFF ¶¶ 1603-1629. In the interest of comprehensiveness, RIAA's proposal has special provisions to address the rare cases where a service obtains download or ringtone licenses directly, and where a record company makes direct sales at retail. A. Finkelstein WRT at 16-18, RIAA Trial Ex. 84. However, the provisions necessary to achieve such comprehensiveness should not distract this court from the fundamental simplicity of RIAA's proposal.

D. The Copyright Owners' Concerns About the Potential for Revenue Manipulation Are Unfounded.

458. The Copyright Owners point to several ways in which they allege that the revenue base in a percentage of revenue rate structure could be manipulated in order to reduce royalties paid to copyright owners. *See* CO PFF Section XIV.D. These concerns are unfounded as applied to RIAA's percentage of wholesale revenue proposal, and find no support in the evidentiary record.

459. First, there is absolutely no evidence in the record that suggests that record companies use their primary product—sound recordings sold as CDs or digital downloads—as a "loss leader" to generate advertising revenue or encourage sales of other products. *See* CO PFF ¶ 610. In fact, the evidence is to the contrary. *See* Eisenberg WRT at 29-30 n.16, RIAA Trial Ex. 89 ("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 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.").

460. Second, the Copyright Owners complain that they would receive different mechanical royalty revenues when products are "bundled" together and sold for less than the sum of their stand-alone parts. *See* CO PFF ¶¶ 612-613. That observation is correct so far as it goes, but misses the larger point—if, as the Copyright Owners propose, mechanical royalty payments must be paid for use of each musical work in a bundle as if it were a stand-alone product and without allocating revenue among the different elements of a bundle, it would make it uneconomical for record companies to offer bundles at prices less than the sum of their parts. That means fewer sales and lower overall revenues. *See* RIAA PFF ¶¶ 1646-1654.

461. Third, based on little more than speculation by Dr. Landes, the Copyright Owners assert that music services and record companies could "barter" for the use of music so that the owners of musical work copyrights would receive no compensation. *See* CO PFF ¶ 617. It is certainly not obvious how record companies could structure significant volumes of barter transactions that nonetheless would allow them to support the production of new recordings, pay their artists and staff, buy advertising for their recordings and carry out all of their other functions. Nor is there any evidence in the record to support the Copyright Owners' barter theory. The Copyright Owners' theory rests exclusively on a snippet of the Copyright Owners' questioning of Andrea Finkelstein about an agreement between SONY BMG and MySpace. CO PFF ¶ 617. The Copyright Owners assert (without citation to Ms. Finkelstein's testimony or anything else in the record) that equity in MySpace "was indisputably given in exchange for the content, including the mechanical rights." CO PFF ¶ 871. But the evidence does not support the Copyright Owners' claims: Ms. Finkelstein testified that "I'm not familiar with the actual terms of that" deal, and to the extent she was familiar with "[a] deal such as the MySpace deal," the equity investment would be "[b]eyond" payment for content. 5/12/08 Tr. 5717:20-5719:2 (A. Finkelstein).

462. Putting aside the lack of evidentiary support, the Copyright Owners' concern is not justified—RIAA's rate proposal defines the revenue base as "revenue recognized by the licensee in accordance with Generally Accepted Accounting Principles," not as cash receipts. *See* RIAA Second Amended Rate & Terms Proposal Section II.A. If a situation were to arise in which a record company earned what is properly recognized as revenue under GAAP (whether paid or payable in cash or otherwise), then it would count as revenue under RIAA's proposal.

463. Fourth, the Copyright Owners suggest that under a percentage rate structure, their mechanical royalty payments would be reduced by discounts made by record companies to distributors. *See* CO PFF ¶¶ 618-620. But recognition of discounts represents nothing more than the unremarkable proposition that the royalty should be based on the actual amounts that the record company can earn in the marketplace, not an arbitrary list price. As Ron Wilcox explained, "list prices, where they exist at all, are imaginary, or perhaps wishful thinking, but not a firm foundation on which a royalty rate structure can be built." Wilcox WDT at 35, RIAA Trial Ex. 70. The Copyright Owners' percentage royalty proposal is likewise based on amounts that are paid or payable, not on a list price. Copyright Owners' Amended Proposed Rates and Terms Section II.1 & II.5. Even Dr. Landes's analysis of the Copyright Owners' cents rate proposal for physical products is based on revenues, not list price. CO PFF ¶ 547.

464. The Copyright Owners are particularly interested in co-op advertising. CO PFF ¶¶ 619-621. These are advertising expenses record companies pay to retailers. Like other forms of advertising expenses, they are accounted for as expenses. Barros WDT at 9, RIAA Trial Ex. 74. It is not proposed that they be treated as a deduction from revenue.

465. Fifth, under RIAA's Second Amended Rate Proposal, in the infrequent situation in which a record company is a direct retailer, RIAA has proposed that the record company's wholesale revenue should be calculated as 70% of retail revenue for physical products and permanent downloads, and 50% of retail revenue for other products. *See* RIAA Second Amended Rate & Terms Proposal Section II.C. The Copyright Owners complain that there is no "empirical support for the 70% and 50% assumption[s]." *See* CO PFF ¶ 622. That criticism, however, is baffling because it completely ignores the extensive record evidence that supports

RIAA's proposal. Indeed, the Copyright Owners' findings of fact point to ample marketplace support for these figures. *See, e.g.*, CO PFF ¶¶ 601, 604.

E. That Record Companies Include Cents Rate Minimums in Some of Their Contracts Is Irrelevant.

466. The Copyright Owners set forth a long list of examples of record company contracts with digital music services that have a cents rate component (generally a percentage of revenue royalty with a cents rate minimum). CO PFF ¶¶ 600-604. These agreements are irrelevant to the question of whether the statutory mechanical royalty rate should be a cents rate or a percentage rate, because record companies as mechanical licensees are situated very differently than the services that are parties to these agreements. As the Copyright Owners explain, service providers have diverse interests that are not necessarily aligned with those of record companies. CO PFF ¶ 605. By contrast, as described above, the interests of record companies and the Copyright Owners concerning generation of revenue from the sale of music are highly aligned.

467. An implication of the discussion in the Copyright Owners' Proposed Findings of Fact is that if this Court were to adopt a percentage rate, it should adopt a cents rate minimum. Given the diversity of prices for the numerous types of uses covered by Section 115, and downward pricing pressure in the marketplace, setting a minimum royalty that does not unduly constrain new products and business models or result in an unfair allocation of value between record companies and the Copyright Owners would be every bit as hard as determining a fair cents rate without a percentage component. Fortunately, such a "greater of" structure is unnecessary here in view of the close alignment of interests between record companies and the Copyright Owners.

F. A Percentage of Revenue Rate Structure Is Needed to Develop New Products and Business Models.

468. The Copyright Owners next contend that a percentage of revenue rate structure is not needed because the digital market is "booming" and record companies have been able develop "a vast array of new products and services" under a penny rate. *See* CO PFF ¶ 623. They argue that the record companies' contributions have been so effective—leading to "dramatic growth" in the download market and "innovation and new product development"—that it is unnecessary to foster continued growth and innovation through the adoption of a cents rate. *See* CO PFF ¶¶ 624, 626; *see generally* CO PFF Section XIV.E.

469. To be sure, RIAA does not dispute that record companies have made major contributions to developing the digital marketplace and creating innovative new products and business models. But those efforts have been in spite of, not because of, the cents rate. The evidence discussed in great detail in RIAA's Proposed Findings of Fact clearly demonstrates that the cents rate has slowed the growth of the marketplace, made it extremely difficult to launch new products, and threatened the viability of numerous innovative offerings and business models that would be more likely to succeed under a percentage of revenue rate structure. *See* RIAA PFF Section VI.B-C.

G. Evidence from International Markets Demonstrates a Percentage of Revenue Rate Structure Confers Important Benefits.

470. The Copyright Owners offer selective evidence from international markets as part of their assertion that a percentage of revenue rate structure is not necessary. CO PFF Section XIV.F. This evidence does little to examine the widespread use or effects of percentage rates internationally, but merely offers a cavalier view that the U.S. music industry does not need the advantages currently enjoyed by the many nations that use percentage rate structures.

471. The Copyright Owners' contention is, simply stated, that the U.S. digital market is growing faster than in other nations that use a percentage of revenue rate. CO PFF ¶¶ 634-636. There is never any suggestion, of course, that it is because the U.S. has had a cents rate that it has outpaced other markets in digital growth. And, there is never any suggestion that the U.S. digital market will grow more with a cents rate structure than with a percentage rate structure. Instead, the Copyright Owners' suggestion is that even with this handicapped royalty structure—almost a complete aberration to the rest of the global music marketplace—the U.S. digital market is still able to grow. Even if true, that meek contention offers this Court no reason to believe that a cents structure should be retained or that a percentage of revenue structure should not be adopted.

472. Notably, the Copyright Owners ignore the evidence from international markets on the many benefits of the percentage rate structure. The United States is one of the few nations in the world not to use a percentage royalty structure for mechanical licensing. RIAA PFF ¶ 1588. Our isolated status in this regard works to the detriment of U.S. consumers and the U.S. music industry. RIAA has detailed at length why retaining a cents rate structure results in U.S. consumers receiving fewer tracks on albums than foreign consumers receive, makes U.S.-produced albums uncompetitive abroad, forces U.S. record companies to lose projects, and limits the ability to offer more mid-line and budget products to U.S. consumers. RIAA PFF ¶¶ 1589-1593. This is the evidence most useful to the Court from international markets, as it directly speaks to the net negative effect on the United States of retaining the cents rate structure.

473. The Copyright Owners' reference to the recent settlement of Canadian physical product mechanical royalties similarly offers no evidence to this Court as to the more preferable rate structure. CO PFF ¶ 637. All that the Copyright Owners can say is that there was an

agreement in Canada and it contained a cents rate (which, it bears noting, is lower than the current U.S. rate). The Copyright Owners never take the necessary next step to then evaluate the incremental effect of a cents rate structure on the Canadian music market. By contrast, RIAA offered this Court evidence from international markets demonstrating that adopting a percentage rate structure here will incrementally benefit U.S. consumers and companies in ways that the same structure has benefited the consumers and music industry in other nations.

H. A Percentage of Revenue Rate Structure Would Not Be Disruptive.

474. RIAA recognizes that the adoption of a percentage rate structure would be a change from the status quo. It has therefore proposed a transition proposal to enable the parties to implement the new rate structure in their computer systems used for mechanical royalty processing and to make any other necessary adjustments to their business practices. *See* RIAA Second Amended Rate & Terms Proposal Section III; RIAA PFF ¶¶ 1657-1665.

475. But that effort to achieve a smooth transition is a far cry from suggesting that the switch to a percentage rate proposal would have a disruptive impact on the *structure of the industries* under the fourth statutory objective. 17 U.S.C. § 801(b)(1)(D). As RIAA explained in detail in its Proposed Findings of Fact, the evidence in the record makes clear that a percentage rate structure would not be disruptive to the Copyright Owners. *See* RIAA PFF ¶¶ 1487-1501.

476. The Copyright Owners now argue that, based on testimony by EMI Music Publishing's Mr. Faxon, a percentage rate structure "would disrupt existing contractual relationships between music publishers and songwriters" because it would cause "EMI MP to renegotiate hundreds of songwriter agreements." CO PFF ¶¶ 645-646. RIAA extensively briefed its response to Mr. Faxon's claims in its Proposed Findings of Fact, and will not belabor the argument here by repeating it, except to incorporate its previous argument by reference. *See*

RIAA PFF ¶¶ 1491-1501. Suffice it to say that the Copyright Owners' argument fails to establish disruption under the fourth statutory objective.

477. The Copyright Owners also briefly contend that switching to a percentage rate would make the auditing process "more difficult." CO PFF ¶ 648. There is scant evidence in the record to support such a claim, and in fact the evidence shows that it is the Copyright Owners' proposed multi-part rate structure for ringtones—the greater of a percentage of retailer revenue, a fraction of "total content costs," and a per-song cents rate subject to adjustment based on changes in the CPI—that is much more complicated than RIAA's proposal and would be more difficult to administer. *See* RIAA PFF ¶¶ 1752-1757.

478. In any event, the Copyright Owners' claim that it would be "more difficult" to conduct audits under a percentage of revenue rate structure, even if it were true, certainly falls far short of establishing that a switch to a percentage rate would "directly produce[] an adverse impact that is substantial, immediate and irreversible in the short-run because there is insufficient time for either [of the parties] to adequately adapt to the changed circumstances." *SDARS Decision*, 73 Fed. Reg. at 4097. Indeed, RIAA's proposed transition period—which is lacking in the Copyright Owners' Amended Rate Proposal—would ensure that the parties would be able to adapt to changed circumstances with adequate time to make the necessary adjustments.

VIII. RATE PROPOSALS AND TERMS

A. The Copyright Owners' Rate Proposal Is Flawed.

1. The Copyright Owners' Proposed CPI Adjustments Have No Basis in the Record.

479. As RIAA explained in its Proposed Findings of Fact, the Copyright Owners have not provided a single agreement—or any other evidence—establishing the appropriateness of the proposed CPI adjustments to each of their proposed rates. *See* RIAA PFF Section VIII.A.2.

480. Nowhere in their Proposed Findings of Fact do the Copyright Owners even try to justify these CPI adjustments. Indeed, in arguing (wrongly) for the appropriateness of their proposed rates, they simply ignore the CPI adjustments and discuss only their proposed first-year rates. CO PFF ¶ 547, 551-552, 555. The Copyright Owners' failure of proof requires rejecting the CPI portion of their rate proposal.

481. Nor is the complete lack of evidence and justification surprising. There is no sound reason to impose CPI-adjusted mechanical royalty rates in an environment of falling prices. Moreover, a CPI increase is inconsistent with Copyright Owners' own claim that there should be a constant ratio between the amounts that Copyright Owners are paid and the wholesale price of sound recordings. Falling prices ensure that if a cents rate is adopted, the balance of relative compensation will shift during the rate period—as it has in recent years due to falling prices and the step increases in mechanical royalties agreed to in 1997. Adjusting rates upward based on the CPI as prices fall just accelerates that trend. Indeed, this Court has twice rejected arguments for CPI increases for precisely these reasons—they are unsupported by any marketplace agreements and it is inappropriate to grant copyright owners increases of indeterminate size. *E.g., SDARS Decision*, 73 Fed. Reg. at 4098 n.42. The proposed CPI adjustments must be rejected.

2. The Copyright Owners' Proposed "Greater of" Rate Structure for Long Works Has No Basis in the Record.

482. As RIAA also explained in its Proposed Findings of Fact, the Copyright Owners have failed to provide evidence to support their proposed "greater of" structure for longer works under each of their proposed rates. *See* RIAA PFF Section VIII.A.3. The Copyright Owners offer no evidentiary support or justification in their Proposed Findings of Fact for their proposed "greater of" structure for longer works. Like the proposed CPI adjustments, the "greater of"

structure is ignored in the discussion of the supposed appropriateness of their proposed rates. CO PFF ¶¶ 547, 551-552, 555.

483. Indeed, all the evidence in the record suggests that longer works are not worth more than shorter ones. RIAA PFF ¶ 1735-1736. Accordingly, the proposed greater of structure must also be rejected.

3. The Copyright Owners Presented No Evidence Supporting Higher Rates for DPDs Than for Physical Phonorecords.

484. Although the Copyright Owners have proposed a higher rate for digital downloads than for CDs and other physical products, they provide no evidentiary foundation for this proposal. The only section of their Proposed Findings of Fact that might be construed as an attempt to support a higher rate for digital downloads is the section entitled, "Consumers Prefer Permanent Downloads for a Variety of Reasons," *see* CO PFF ¶¶ 389-392. The Copyright Owners make two arguments here, neither of which supports a higher mechanical rate for digital downloads.

485. First, the Copyright Owners cite testimony from Claire Enders for the proposition that consumers like certain features of the digital music market. CO PFF ¶¶ 390-91. As an initial matter, this impressionistic testimony does not quantify the alleged higher market value of these features. The fact that consumers like various features of digital music says nothing about how they value those features relative to the features of physical phonorecords. In addition, as RIAA has already explained in its Proposed Findings of Fact, Ms. Enders' testimony before this Court is completely lacking in credibility given her out-of-court statements to the complete contrary. In her March 2007 Enders Analysis report on "Recorded Music and Music Publishing," Ms. Enders stated in no uncertain terms that consumers do not value downloads

more than CDs: "Compared to physical formats, consumers tend to attribute a lower value to the single track or album download." RIAA Trial Ex. 27 at 14.

486. Indeed, the market is the best measure for how consumers view the relative value of CDs and digital downloads, and there the message is clear—digital downloads of albums are valued less than, not more than, CDs. Ms. Enders testified that the prevailing price for a CD is $13.24, but the price for the same sound recordings sold in digital album form is $9.99. Enders Amended WDT at 22, CO Trial Ex. 10. Digital singles sell for 99 cents each—which, based on 13 tracks per CD, is less than the prevailing price for each sound recording on a CD. Enders Amended WDT at 22, CO Trial Ex. 10. As Mr. Benson's analysis of wholesale prices shows, record companies receive about the same (actually slightly less) per track for digital downloads than they do for tracks on CDs and far less per track for digital albums than for tracks on CDs. Benson WRT at Figure 4, RIAA Trial Ex. 82.

487. The second argument that the Copyright Owners make concerning consumer preference for permanent downloads is even weaker. They cite internal research from Apple setting forth reasons why Apple consumers choose to purchase music online. CO PFF ¶ 392. Aside from the fundamental problem with citing Apple's internal consumer survey data for the proposition that consumers prefer digital music (since the only consumers surveyed are those who have that preference), this survey says nothing about the market value of digital music relative to CDs. Again, the fact that there are reasons that people purchase music online is irrelevant to whether mechanical rates for DPDs should be different than for physical products.

488. Ultimately, the Copyright Owners presented no market evidence that consumers value digital downloads more than physical CDs, and did not even try to quantify any different consumer valuation between downloads and physical products. In any event, as discussed in

RIAA's Proposed Findings of Fact, if the market evidence shows anything, it is that consumers value physical CDs more than digital downloads. *See* RIAA PFF ¶¶ 1713-1723.

4. The Copyright Owners' Proposed Rate Structure for Ringtones is Incoherent and Unworkable.

489. The Copyright Owners have proposed a complicated and unclear rate structure and revenue definition for ringtones that is not workable in the marketplace. Specifically, the Copyright Owners have proposed a royalty rate for ringtones that is the greatest of (1) 15% of revenue (as specially defined), (2) 15 cents (subject to the inappropriate CPI adjustments discussed above), and (3) one third of total content costs. CO Amended Proposed Rates And Terms Section I.3. RIAA has addressed the inappropriateness of the quantum of these rates elsewhere. *See* RIAA PFF ¶¶ 967-985. Here RIAA addresses the flawed proposed rate structure.[17]

490. As an initial matter, it is important to recognize that despite their criticisms of a percentage royalty rate structure, CO PFF Section XIV, the Copyright Owners have (appropriately) embraced the concept of a percentage royalty. Given the range in retail prices of ringtones noted by the Copyright Owners, CO PFF ¶ 396, and recent softening in ringtone prices, Eisenberg WRT at 6, RIAA Trial Ex. 89, a percentage rate is most appropriate for ringtones just as for other types of products. RIAA PFF Section VI. The Copyright Owners' criticisms of a percentage royalty rate structure must be viewed as relatively minor when such structures are

[17]DiMA's proposed royalty base is also susceptible to criticism when applied in the case where a record company is the licensee, because it is retail-oriented and would seem to double-count revenue of the licensee record company and its "carrier(s)" (presumably digital music services). Second Amended Proposed Rates and Terms of DiMA § 380.2(a)(1). RIAA does not understand it to be the intention of DiMA's rate proposal to address cases where the record company is the licensee or to reach wholesale revenues of a record company.

used almost everywhere else in the world, RIAA PFF ¶¶ 1587-1589, and are proposed by them in this very proceeding.

491. RIAA proposed a percentage rate with clear and objective revenue allocation rules and a rigorously-defined royalty base anchored in accounting principles used for royalty payments throughout the music industry and in the larger economy, *see* RIAA PFF ¶¶ 1505-09, 1630, in the Copyright Office's Section 115 regulations, *see* RIAA PFF ¶¶ 1622-1623, and even in the report of the Copyright Owners' expert Dr. Landes. CO PFF ¶ 547.

492. Unlike RIAA, the Copyright Owners tried to invent a vague system of accounting unmoored from the principles of revenue recognition and allocation that are required under Generally Accepted Accounting Principles and used in the Copyright Office's Section 115 regulations, RIAA PFF ¶¶ 1622-1623, and in the regulations recently adopted by this Court in the SDARS proceeding, 37 C.F.R. § 382.11. The result of that effort is a proposal that requires payment of an uncertain amount, and seemingly a high proportion of a service's total overall revenue, for each ringtone sold. To see why this is so, it is instructive to try to apply the Copyright Owners' proposed definitions.

493. The core of the Copyright Owners' definition of revenue is "monies and any other consideration paid or payable to, or received, earned, accrued or derived by, a User by or from any party in connection with a Licensed Service or a Licensed Product." CO Amended Proposed Rates And Terms Section II.1. Other definitions provide that a User is a retailer or the affiliate of a retailer (CO Amended Proposed Rates And Terms Section II.6), a Licensed Product is a ringtone (CO Amended Proposed Rates And Terms Section II.2), and a Licensed Service is a "digital music service that provides ringtones" (CO Amended Proposed Rates And Terms Section II.3). The Copyright Owners then provide a long list of different types of consideration

that might be included within their definition of revenue, although this list is just illustrative, so it is the initial clause that is operative.

494. Attempting to apply this definition makes clear just how vague and unworkable it is. By way of example, as the Copyright Owners describe, the major wireless operators sell mastertones, and full track downloads to both the phone and PC. CO PFF ¶¶ 396-397. Record companies have agreements with wireless carriers covering the full range of music products, including ringtones, downloads, videos and more. Wilcox WDT at 15-16, RIAA Trial Ex. 70. If a record company were to try to compute its mechanical royalty liability for ringtone sales using the Copyright Owners' proposed structure, the cellular carrier would be the "User," and each ringtone would be a "Licensed Product." Exactly what constitutes the carrier's "Licensed Service" under the Copyright Owners' proposal is less clear. The definition is clearly drafted to be broader than "Licensed Product," so it cannot be just the carrier's sale of ringtones of the particular musical work at issue. In fact, the definition seems to encompass the carrier's whole digital music service (not only the particular ringtone at issue but other ringtones, and permanent downloads, videos and other musical products).

495. Read literally, the Copyright Owners' proposal could lead to absurd results. Under the revenue prong of the Copyright Owners' royalty proposal, a record company that sold ringtones through a carrier would owe no less than 15% of revenue – that is, 15% of all monies and other consideration paid or payable to, or received, earned, accrued or derived by, the carrier by or from any party in connection with its digital music service (the Licensed Service) or a ringtone (the Licensed Product). What consideration is paid to the carrier "in connection with" the ringtone? The full price of bundles of which the ringtone is part (*e.g.*, where a ringtone coupled with a full-song download, the price paid for both)? Payment for other products offered

on the same page of the service? Payment for the mobile service necessary to access the ringtone? If that language was not broad enough to reach well beyond any appropriate royalty base, certainly "in connection with" the carrier's digital music service would do so. The rate request is designed to reach beyond ringtones to capture revenue from full-song downloads, videos and the other musical products that carriers sell. Although it is hard to believe that this is intended, the language of the Copyright Owners' proposal would seem to require payment of 15% of the overall revenues of the carrier's service for each ringtone sold.

496. It would be natural to assume allocation rules such as those proposed by RIAA, *see* RIAA Second Amended Rate & Terms Proposal Section II.D-E, although in view of the Copyright Owners' critique of such provisions, CO PFF ¶¶ 612-613, it is not clear that assumption is warranted.

497. Indeed, the Copyright Owners' definition of revenue cannot be squared with the primary benchmark on which their ringtone proposal purports to rely—the NDMAs. In the NDMAs, the retail price of the ringtone (the Licensed Product) is used to calculate payments. Wilcox WDT at 28, RIAA Trial Ex. 70. The NDMAs thus do not involve a broader, value royalty base that the publishers have proposed. The Copyright Owners' attempt to persuade this Court to adopt a revenue definition different from and broader than that in the NDMAs simply reflects one of the ways (along with the higher percentage rate and higher cents rate in their rate proposal) in which the Copyright Owners are attempting to obtain a substantial increase even beyond the inflated royalty rates for mastertones in the NDMAs. But because the Copyright Owners' definition of revenue is so unclear, it is simply impossible to know how much more record companies would end up paying for mastertones. Although the NDMAs have many flaws and are totally useless as a benchmark for setting rates and terms for CDs and digital downloads,

at least the revenue definition embodied therein is one that exists in the marketplace and under which the parties have experience operating.

498. The Copyright Owners' proposal is also flawed because it could be construed to require double payment. The proposed royalty base includes consideration that is paid, payable, received, earned, accrued or derived. CO Amended Proposed Rates And Terms Section I. Some of those events are synonymous and others are separate and happen at different times. For example, one might expect consideration to be accrued when earned, resulting in an obligation that becomes payable and at some later date is actually paid/received. Presumably the Copyright Owners do not expect to collect 15% of the amount that is earned/accrued from a sale and another 15% of that same amount when it is paid/received, but the language of the definition they have proposed suggests that double payment might be required.

499. The revenue prong is just one element of the Copyright Owners' rate request for ringtones. They also define "Total Content Costs" as "all of the types of consideration comprising Revenue that are paid or payable to the Licensor of sound recording rights and/or the Licensor of mechanical rights in connection with a Licensed Service or Licensed Product." CO Amended Proposed Rates And Terms Section II.5.

500. If the Total Content Costs provision of the Copyright Owners' greater of proposal were to apply, the record company would owe "one-third of the total content costs paid for mechanical rights to musical compositions and rights to sound recordings." CO Amended Proposed Rates And Terms Section I.3(c). The use of the plural in this provision is important, because this proposal does not contemplate payment for use of a single musical composition as Section 115 requires. Instead of looking at the payments made for the use of one musical work, the Copyright Owners ask for one-third of payments to the record company or to music

publishers "in connection with" a carrier's digital music service (Licensed Service) or a ringtone (Licensed Product). CO Amended Proposed Rates And Terms Section II.5.

501. The Copyright Owners' "greater of" proposal also lacks time coherence. The record reflects that record companies and publishers sometimes receive advances from music services. *See* RIAA PFF ¶¶ 1805-1813. It is elementary that such advances cannot be booked as revenue until earned, but under the Copyright Owners' proposal, mechanical royalties based on them would seem to be payable as soon as a contract was signed. Thus, in the month that a record company or publisher signed a contract to receive an advance, that advance would count in the Copyright Owners' royalty base, resulting in a windfall for the Copyright Owners of works distributed that month, but leaving no payment to Copyright Owners of works distributed over the rest of the term of the contract as the advance is earned.

502. Contrary to the Copyright Owners' incoherent proposal, RIAA's rate proposal (as well as the Copyright Office's regulations, this Court's SDARS Decision and the many contracts requiring payment on a percentage of revenue basis) operates sensibly based on well-established accounting principles. These principles have evolved over many years to address the sorts of complexities addressed here. The definition of wholesale revenue is already used in the industry to calculate artist royalties, a substantial stream of payments made every day by the record companies. Kushner WDT at 5, RIAA Trial Ex. 62; CO Trial. Ex. 56 at RIAA0036272; 2/14/08 Tr. 3471:15-21 (Kushner); Eisenberg WRT at 9, RIAA Trial Ex. 89; A. Finkelstein WRT at 16, RIAA Trial Ex. 84; *see also* 5/12/08 Tr. 5662:10-14 (A. Finkelstein) ("[T]he entire artist royalty structure is based on a percent of revenue . . . that's the same basis on which we make payments to producers, to labels and to . . . the musicians unions"). Moreover, the definition of revenue in RIAA's rate proposal is essentially the same as the revenue definition in the agreements that the

Copyright Owners themselves advance as benchmarks (the NDMAs). A. Finkelstein WRT at 14, RIAA Trial Ex. 84; Faxon WDT at Ex. 219 at 15, CO Trial Ex. 3; Faxon WDT at Ex. 220 at 24, CO Trial Ex. 3; Faxon WDT at Ex. 221 at 22, CO Trial Ex. 3; Firth WDT at Ex. 332 at 19, CO Trial Ex. 24. By trying to jettison these well-established principles and invent their own system of accounting, the Copyright Owners have created a hopelessly unworkable mess that cannot be adopted as a statutory royalty rate.

B. The Copyright Owners' Objections to RIAA's Proposed Terms Do Not Withstand Scrutiny.

503. As addressed more fully in RIAA PFF Section IX.B, the terms proposed by RIAA are reasonable and appropriate. In opposing these terms, the Copyright Owners ignore the evidence in the record and seek the imposition of regulatory requirements completely at odds with marketplace practice. These sorts of regulatory requirements are significant reasons why the compulsory license is almost never used, and the Copyright Owners' proposals would only make those burdens more significant. Moreover, the Copyright Owners' vehement insistence on the importance of practices that are almost never carried out can only be explained as an effort to ensure that the compulsory license does not lend itself to "reasonable resort." *1981 Mechanical Royalty Proceeding*, 46 Fed. Reg. at 10480. This Court should resist those efforts and take whatever steps it can to make the Section 115 compulsory license genuinely useable.

504. This Court has previously expressed a desire to "adopt royalty payment and distribution terms that are practical and efficient." *SDARS Proceeding*, 73 Fed. Reg. at 40988 (quoting *Webcasting II Proceeding*, 72 Fed. Reg. at 24102). RIAA's proposals are designed to achieve that desired objective.

1. Accounting for DPDs

505. As explained in RIAA PFF ¶¶ 1765-1766, RIAA has set forth a term addressing the timing of accounting for DPDs only in case the Court disagrees with RIAA's view that the Court lacks jurisdiction to adopt this term. *See* RIAA COL Section V.B.1. If the Court concludes that it does have jurisdiction to adopt this term, it is well-justified as a factual matter.

506. In opposing this term, the Copyright Owners mischaracterize the testimony of Andrea Finkelstein as lacking factual support. CO PFF ¶ 877. Ms. Finkelstein explained in her written testimony that "[t]he twenty day payment cycle simply does not allow services enough time to complete their month-end accounting cycle, report to record companies, and then for record companies to do the same to report to publishers." A. Finkelstein WRT at 25, RIAA Trial Ex. 84. As the person who supervises the department that processes data concerning usage reported by services in order to report and pay mechanical royalties to music publishers, Ms. Finkelstein is certainly in a position to know the timing of that data flow and processing cycle. A. Finkelstein WDT at 1-2, RIAA Trial Ex. 61; 5/12/08 Tr. 5754:6-5755:6 (A. Finkelstein) (describing the effort needed to aggregate and process the necessary data and review nearly 20,000 accounting statements for an accounting cycle).

507. Section 115's monthly payment cycle and short 20-day accounting period have discouraged use of the compulsory license for decades, during most of which time record companies needed only account for their own distribution of physical phonorecords. Now that mechanical royalty payments require two complete accountings—one by the services and then one by the record companies—it is obvious that Ms. Finkelstein is right: the 20-day cycle is too short. *See* 5/12/08 Tr. 5756:16-5757:18 (A. Finkelstein) (describing the "very, very quick turnaround" as a reason record companies do not use the compulsory license).

508. The marketplace has recognized for decades that a 20-day payment cycle is impracticable, and voluntary mechanical license agreements almost always provide a 45-day payment cycle. A. Finkelstein WRT at 25, RIAA Trial Ex. 84. Agreements between record companies and services support Ms. Finkelstein's testimony. Merely by way of example, SONY BMG's agreement with Nokia has detailed requirements for reporting the kind of data that is necessary for SONY BMG to process mechanical royalty payments, and provides that those reports will be delivered to SONY BMG [ ]. CO Trial Ex. 352, App. 5. Universal's agreement with Apple likewise has detailed reporting requirements and provides that reports will be delivered to Universal [ ]. CO Trial Ex. 93, App. A § 5(b). Given that these reporting obligations must be completed before a record company can begin the process of reporting to a music publisher, it is not possible for a record company to report to a publisher within 20 days.

509. Similarly, this Court has adopted 45-day payment cycles under Sections 112 and 114. 37 C.F.R. § 382.13(c) (SDARS); 37 C.F.R. § 380.4(c), (d) (webcasting). Whereas in those instances a service need only report to SoundExchange within 45 days, under Section 115 there is an extra step as services need to report to record companies and record companies to publishers.

510. Furthermore, treating DPDs as distributed when reported, and thereby conforming the Section 115 payment cycle to that applicable in the marketplace and under Section 114 (if this Court has the authority to do so) would materially enhance usability of the compulsory license. A. Finkelstein WRT at 25, RIAA Trial Ex. 84. RIAA thus urges the Court to adopt this term if it finds that it has the authority to do so.

2. Signing Statements of Account

511. The current requirement concerning signing of statements of account is another real impediment to applying the Section 115 compulsory license to the practical realities of modern business. The Copyright Owners have not presented any reasonable rationale justifying this requirement.

512. RIAA does not contend that it is difficult to have an officer of a record company sign a handful of accounting statements each month. However, just one major record company (SONY BMG) renders mechanical royalty statements to 15,000-20,000 payees in an accounting cycle. 5/12/08 Tr. 5754:6-5755:6 (A. Finkelstein). If there were to be large-scale use of the compulsory license, an officer of the corporation could not engage in the kind of searching review of 20,000 statements that the Copyright Owners imagine. CO PFF ¶ 878. Certainly, he or she could not do so in the final days of a 20 day accounting period. The review would have to be like the kind that occurs today in voluntary transactions, where review is delegated to royalty accounting staff, not carried out personally by senior officials. 5/12/08 Tr. 5754:22-5755:6 (A. Finkelstein).

513. The Copyright Owners' suggestion that officers are uniquely qualified to review royalty accounting statements has no basis in the record. The current regulations do not impose any particular qualifications on the officers who sign accounting statements. They need only be officers. 37 C.F.R. § 201.19(e)(6), (f)(6). There is no reason to believe that the royalty accounting staff who prepare and review royalty statements in the ordinary course of business are less qualified to review accounting statements than any arbitrary officer of the corporation.

514. If there were large-scale use of the compulsory license, there would, in Judge Roberts' words, be "some poor fellow at Sony whose hand is worn out applying . . . his or her signature to the statements of account." 5/12/08 Tr. 5758:1-3 (A. Finkelstein). In sum, there is

no reason that person needs to be an officer of the corporation and the very requirement makes widespread use of the compulsory license functionally impracticable.[18]

3. Audits

515. In opposing RIAA's proposal concerning the means by which record companies verify their statements of account, the Copyright Owners again ignore the testimony in the record. As explained in RIAA PFF Section IX, the current regulations impose burdensome certification requirements on top of other audits that record companies conduct. The evidence shows that record companies conduct annual audits and are also regularly audited by publishers. A. Finkelstein WRT at 26, RIAA Trial Ex. 84; 5/12/08 Tr. 5759:4-5760:5 (A. Finkelstein). The Copyright Owners in fact make much of HFA's extensive auditing program. CO PFF ¶ 846. The Copyright Owners have not explained how the burdensome certification requirement advances any interest in this proceeding. If Section 115 is to have a chance of being used, this Court should adopt RIAA's proposed provision.

4. Covered Reproductions

516. The Copyright Owners indicated in a footnote that RIAA's proposed term concerning covered reproductions is resolved by the settlement announced to the Court on May 15, 2008. That settlement concerns interactive streams and limited downloads, not other configurations. For example, the copies made on servers to enable delivery of ringtones and permanent downloads are outside the scope of the settlement. Accordingly, the Court should adopt RIAA's proposed term with respect to product configurations not covered by the

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[18] Contrary to the Copyright Owners suggestion, CO PFF ¶ 879, RIAA has not proposed elimination of the current certification requirement. Rather, RIAA proposes simply that licensees be permitted to have the certification made by staff who review royalty statements in the ordinary course of business. RIAA Second Amended Rate Proposal Section V.C.

settlement (as proposed in RIAA's draft regulations), for the reasons set forth in RIAA PFF Section IX.B.4.[19]

5. Locked Content

517. The Copyright Owners argue that the element of RIAA's alternative rate proposal addressing locked content is contrary to the provisions of Section 115.[20] That is incorrect.

518. As an initial matter, it is important to recognize that RIAA's alternative rate proposal is not RIAA's preferred option. A percentage of revenue royalty rate structure addresses new delivery technologies and business models like locked content automatically, without the need for specialized provisions like this. It is only if the Court concludes that it is appropriate to try to squeeze new business models like locked content into an inflexible cents rate royalty structure that it would become necessary to consider special provisions that would make those business models practicable.

519. The Copyright Owners' apparent proposal, charging 12.5 cents per physical locked track or 15 cents per downloaded locked track, even if nobody ever buys or even listens to the music, would simply serve to ensure that locked content would never be made available under Section 115 during the coming rate period.[21] *See* Eisenberg WRT at 26-27, RIAA Trial

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[19] To the extent that the parenthetical reference to interactive streams as incidental DPDs in RIAA PFF ¶ 1778 suggested otherwise, RIAA clarifies that the issue of whether interactive streams constitute incidental DPDs is subject to the settlement. The parenthetical was not intended to place the subject matter of the settlement at issue.

[20] This proposal is an integral element of RIAA's proposed rates, not a term of payment, but because the Copyright Owners addressed it together with RIAA's proposed terms, RIAA responds here together with our responses to the Copyright Owners' critique of RIAA's terms.

[21] RIAA believes that locked content most likely would be made available as a physical product or permanent download. To the extent that locked content might involve limited downloads, that would be covered by the settlement announced to the Court on May 15, 2008 and is excluded from this proposal. *See* Draft Regulations Implementing RIAA's Proposed Rates and Terms § 385.1.

Ex. 89. For example, consider the case of 1,000 encrypted tracks preloaded onto a hard drive in the hope that a consumer might buy a few of them. As Mr. Eisenberg explained, it is unlikely that the record company would receive any up-front consideration for placing such locked content on a device. Eisenberg WRT at 26, RIAA Trial Ex. 89. Thus, for the act of preloading the encrypted tracks, even the Copyright Owners' misplaced benchmarks would suggest a royalty of zero (20-50% of a content pool of zero)—not a royalty of $125.

520. If this Court is going to fulfill its statutory duty to set royalty rates "for the activities specified by this section [115]," 17 U.S.C. § 115(c)(3)(C), the royalty must be "a royalty of reasonable resort," *1981 Mechanical Royalty Proceeding*, 46 Fed. Reg. at 10480. Setting a royalty that is utterly unreasonable for a product configurations in the marketplace or likely to be in the marketplace during the rate period would fail to achieve this objective. It is against that backdrop that RIAA has suggested provisions to enable distribution of locked content if this Court is not prepared to adopt a percentage royalty rate structure.

521. RIAA's proposal is consistent with the requirements of Section 115. Under Section 115, "the royalty under a compulsory license shall be payable for every phonorecord made and distributed in accordance with the license. For this purpose, and other than as provided in paragraph (3), a phonorecord is considered 'distributed' if the person exercising the compulsory license has voluntarily and permanently parted with its possession." 17 U.S.C. § 115(c)(2).

522. Even assuming that shipment of locked content constitutes permanently parting with possession,[22] the Copyright Owners' critique of RIAA's proposal fails. The Copyright

[22] Whether that is so may depend on the particular commercial arrangements involved. In addition, it is not clear that a distributor should be considered to have permanently parted with

Owners selectively quote the foregoing provision to omit the key phrase "other than as provided in paragraph (3)." CO PFF ¶ 884. However, in the foregoing provision, "paragraph (3)" refers to Section 115(c)(3), which, among other things, authorizes the Copyright Royalty Judges to set terms of the compulsory license. Thus, this Court is not constrained by the definition of the term "distributed" in adopting terms if necessary to achieve its mandate. Instead, it is specifically authorized by statute to do just what RIAA has proposed—clarify what it means to distribute a new type of product where the generally-applicable definition does not work.

523. Here, the evidence in the record supports RIAA's proposal. *See* RIAA PFF ¶ 1677. Even in the NDMAs that are the basis of the Copyright Owners' rate proposal, in the ordinary case, the mechanical royalty for locked content is payable when the locked content is unlocked. In the unlikely event that the record company received an up-front payment, the agreements would require the record company to share it with publishers. Eisenberg WRT at 26-27, RIAA Trial Ex. 89; Faxon WDT at Ex. 219-221, CO Trial Ex. 3. A percentage rate structure would achieve exactly the same result automatically, because when the up-front payment was recognized as revenue it would be included in the royalty base, and when a purchase payment was recognized as revenue, it also would be included in the royalty base. In a less flexible cents rate system it would be impossible to quantify and address the unlikely occurrence of an up-front payment for locked content, so RIAA's proposal is the best approximation of the marketplace treatment of locked content possible within a cents rate structure.[23]

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possession of a phonorecord over which it exercises dominion by controlling the key to unlocking an encrypted track.

[23] It must be recognized, of course, that the marketplace agreements that address locked content (NDMAs) were package deals and otherwise are inappropriate benchmarks for this proceeding. As RIAA argues elsewhere, one cannot validly look at any one piece of them in isolation and assume that it is reflective of marketplace terms for that piece in a standalone transaction. RIAA PFF ¶¶ 944-63. Moreover, RIAA is not proposing that the locked content provisions of the

524. Finally, this is once more a situation where the Copyright Owners want to have their cake and eat it too. They (wrongly) propose the NDMAs as the benchmark for all rates to be set in this proceeding, but want the Court to ignore that those agreements included other things, like a clear and simple definition of revenue (unlike what Copyright Owners have proposed here), provisions addressing the royalty rates for multisession products, and a provision addressing locked content that made clear that the royalty rate would be based on content actually unlocked, rather than based on the number of sound recordings which are on a device but are inaccessible.

6. Multiple Instances

525. The Copyright Owners also attack the element of RIAA's alternate cents rate proposal concerning treatment of products with multiple instances of the same recording, such as a disc that must be formatted to have multiple sessions to enable play on different devices or in both stereo and surround sound.[24] *See* CO PFF ¶¶ 886-888.

526. Again, it is important to understand that a percentage of revenue royalty rate would appropriately address products with multiple instances of the same recording automatically, without the need for specialized provisions like this. It is only if the Court concludes that it is appropriate to try to squeeze these kinds of products into an inflexible cents rate royalty structure that it becomes necessary to consider special provisions to ensure that

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NDMAs be used as a rate benchmark, but only as an indication of a possible structure for addressing the difficult problem of how this Court can fulfill its mandate to set a reasonable rate for locked content if it determines to adopt an inflexible cents rate structure.

[24] As with locked content, this proposal is an integral element of RIAA's proposed rates, not a term of payment, but because the Copyright Owners addressed it together with RIAA's proposed terms, RIAA responds here together with our responses to the Copyright Owners' critique of our terms.

disputes over interpretation of the statute and regulations to not make these products impracticable.[25]

527. In opposing RIAA's proposal for addressing multiple instances of the same sound recording in a single product, the Copyright Owners have resorted to precisely the same fallacious arguments they have made to delay the introduction of multisession products in the past. Barros WDT at 17, RIAA Trial Ex. 74; A. Finkelstein WDT at 11-12, RIAA Trial Ex 61; Wilcox WDT 23-24, RIAA Trial Ex. 70. By making these arguments in 2004 (as well as raising a host of other disputed issues), they were able to introduce uncertainty concerning the status of DualDiscs, SACDs and other multisession products, and thereby gain leverage to extract high royalty rates for ringtones in the NDMAs. Wilcox WDT 23-30, RIAA Trial Ex. 70.

528. The Copyright Owners contend that RIAA's proposal conflicts with Section 115(c)(2). CO PFF ¶ 887. That provision provides that "the royalty under a compulsory license shall be payable for every phonorecord made and distributed in accordance with the license." The Copyright Owners then imply that the reference to "phonorecord" in that provision means something like "instance of a sound recording."

529. Of course, the statute does not say that. Section 115(c)(2) refers to payment "*for every phonorecord* made and distributed." 17 U.S.C. § 115(c)(2) (emphasis added). It reiterates that the statutory rate shall be payable "[w]ith respect to *each work* embodied *in the phonorecord*." *Id.* (emphasis added).

530. The Copyright Office's regulations implementing Section 115 are completely consistent. Section 255.2 of those regulations specifies that "[w]ith respect to *each work*

[25] This problem obviously could be addressed in ways other than that proposed by RIAA. For example, one could conceive of a special rate class for products with multiple instances, where the rate is an otherwise-applicable cents rate divided by the number of instances of each recording.

embodied *in the phonorecord*, the royalty payable shall be [the rate specified, as adjusted pursuant to Section 255.3] *for every phonorecord* . . . ." 37 C.F.R. § 255.2 (emphasis added). Section 255.3 of those regulations repeats no less than 13 times that the royalty is payable "*for every phonorecord*." 37 C.F.R. § 255.3 (emphasis added). The regulations concerning reporting and the computation of payments are to a similar effect. For example, each report is to include *on a per work basis*, 37 C.F.R. § 201.19(e)(2)(v), "the number of *phonorecords*" made and distributed, 37 C.F.R. § 201.19(e)(3). The royalty is computed by calculating the number of phonorecords distributed (taking into account reserves) and "multiplying . . . by the statutory rate." 37 C.F.R. § 201.19(e)(4)(ii) (Step 5).

531. In the foregoing provisions, a "work" is a musical work. "Phonorecords" are defined by the Copyright Act as "material objects in which sounds . . . are fixed by any method now know or later developed, and from which the sounds can be perceived, reproduced or otherwise communicated . . . ." 17 U.S.C. § 101. Given that a disc is a single "material object" (and not two or more), it is thus apparent that Section 115(c)(2) and the relevant regulations require payment of a single mechanical royalty for each musical work embodied in a disc. Nothing in the statute or the regulations indicates or suggests that the number of instances of a recording of a single work embodied in a disc should compel multiple royalties.

532. To the contrary, for 50 years encoding technology has dictated that products have two separate instances of each sound recording—the left and right stereo channels—and nobody has ever suggested that separate payments are required for each channel. A. Finkelstein WRT, at 24, RIAA Trial Ex. 84. The statute likewise provides absolutely no basis for concluding that stereo and surround sound versions of the same recording on one phonorecord should bear separate cents rate royalties.

533. Even more important, this argument is a red herring. The purpose of this proceeding is to determine the royalty rate that will be payable for phonorecords distributed under Section 115. This Court has considerable discretion in determining what that rate will be, subject to the general principles of rate determination under Section 115 and Chapter 8. *See* RIAA COL Section II. Nothing in the fact that the rate is payable for phonorecords suggests or requires that this Court cannot set a rate for products with multiple instances of the same recording that is appropriate to the economics of those products. To the contrary, this Court must set a reasonable royalty rate for those products, and the rate determined will be the one payable for those phonorecords.

534. For this reason, there is no inconsistency between RIAA's proposal concerning the treatment of products with multiple instances of the same recording and the Copyright Office regulations (or for that matter RIAA's position concerning this Court's authority to adopt terms). If this Court adopts an appropriate royalty rate for products with multiple instances of the same recording, that will be the rate applicable to those phonorecords under the Office's payment regulations.

535. If this Court does not adopt a percentage rate as RIAA has proposed, the record compels the conclusion that this Court should set a rate that does not artificially multiply a record company's payment based on the number of instances of the same recording in a product. Multiple session products are created to enable playability on multiple platforms, and sometimes to enable the copy protection the Copyright Owners have said they want. CO PFF ¶ 362. They have not commanded a material price premium in the marketplace. Barros WDT at 17, RIAA Trial Ex. 74; A. Finkelstein WDT at 11-12, RIAA Trial Ex 61; Wilcox WDT 23-24, RIAA Trial Ex. 70; A. Finkelstein WRT, at 24, RIAA Trial Ex. 84. And while the NDMAs cannot be relied

upon as a marketplace benchmark for rates, *see* RIAA PFF Section IV.D, it is notable that the Copyright Owners agreed therein to license multisession products for the same mechanical royalty as applicable to a CD (including applicable discounts under controlled composition clauses). Wilcox WDT 28, RIAA Trial Ex. 70; Faxon WDT at Ex. 219-221, CO Trial Ex. 3. If this Court does not adopt a percentage rate, RIAA's alternative proposal best addresses the unique circumstances of multisession products.

C. The Copyright Owners' Proposed Terms Lack Evidentiary Support and, with One Exception, Are Contrary to Law.

536. While RIAA's proposed terms are intended to make the Section 115 compulsory license into a tool that might actually be used in modern commerce, the Copyright Owners' proposed terms are intended to exploit the power of this Court to enhance the leverage of the Copyright Owners so that they can seek in future voluntary agreements what they have to date been unable to secure through marketplace negotiations.[26] With one exception, the Copyright Owners' proposed terms are contrary to the great weight of evidence in this proceeding.[27]

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[26] Throughout this proceeding, the Copyright Owners have intimated that they might propose terms supplanting the reserve accounting rules in the Copyright Office's regulations. They never proposed such terms, however, and at this point have waived the right to do so. The Copyright Owners included a definition of revenue in Section II of their Amended Proposed Rates and Terms. While they discuss that definition in the terms section of their Proposed Findings of Fact, *see* CO PFF Section XI.10, that definition is not denominated a "term" in their Amended Proposed Rates and Terms. Accordingly, we do not treat it as a term. Because it relates solely to their proposed ringtone rates, we address that definition in our discussion of ringtone rates. *See* RIAA RPFF Section VIII.A.4.

[27] RIAA does not object to the Copyright Owners' proposal to apply the rates determined in this proceeding to phonorecords distributed after the effective date of such rates, regardless of the date of manufacture, subject to RIAA's proposed transition period. However, RIAA does take exception to the Copyright Owners' charge that record companies have misapplied the effective date provisions of previous Section 115 royalty rates. As the Copyright Owners describe, those rates have applied to phonorecords "made and distributed" after a certain date. That language could not be more clear that the new rates do not apply to products manufactured before the effective date and distributed after (*i.e.*, ones distributed, but not made, after the effective date).

537. As RIAA has described elsewhere, with one exception, the Copyright Owners' proposed terms are also contrary to law. RIAA COL Section V.C; RIAA RCOL Section VI.

1. Late Fee

538. The Copyright Owners' Proposed Findings of Fact confirm the audacity of their proposed late fee. The Copyright Owners state in no uncertain terms that in the marketplace, HFA cannot add a late payment fee to its licenses because there is too much "resistance." CO PFF ¶ 859. That is crystal clear evidence that their proposal is contrary to the market. The Copyright Owners also freely admit that the real purpose of the proposal is to get "a late fee in the Fox license." CO PFF ¶ 860. This Court must adopt reasonable terms for a compulsory license, not act to enable Copyright Owners to secure in their voluntary licenses what they have generally been unable to obtain in the marketplace.

539. There is no dispute that record companies are not always able to make payments when due. However, the evidence shows that writers and publishers are overwhelmingly the cause of most late payments because they want recordings to be released as soon as they are completed and then often wait months to negotiate splits of ownership of the new musical works embodied therein. *See* RIAA PFF Section IX.C.1.b.

540. There is also no dispute that record companies pay tens of millions of dollars in advances to cover at least some late payments. The Copyright Owners mischaracterize the evidence in this regard. They correctly note that Ms. Finkelstein's written testimony explained that record companies pay such advances. However, they call that testimony "inaccurate[]" based on oral testimony of Ms. Finkelstein and Mr. Pedecine. CO PFF ¶ 857. It is the Copyright Owners' characterization of the oral testimony that is inaccurate. Ms. Finkelstein testified at trial

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As the Copyright Owners themselves acknowledge, that is how record companies have applied that provision. CO PFF ¶ 867.

that the advances cover "any late payment reason." 5/12/08 Tr. 5691:16-21 (A. Finkelstein). As Chief Judge Sledge recognized at the time, the portion of Ms. Finkelstein's testimony cited by the Copyright Owners refers to custom and practice concerning collection of the late fee provided in some HFA licenses, not to the late fee proposed by the Copyright Owners here. 5/12/08 Tr. 5687:9-5690:13 (A. Finkelstein). Thus, Ms. Finkelstein's testimony is consistent that the Copyright Owners are requesting late fees in this proceeding that would cover late payments for which record companies pay advances.

541. The Copyright Owners also cite testimony of Mr. Pedecine. However, he gave varying answers concerning what he believes the advances cover. The Copyright Owners' proposal contains no express exclusion of situations covered by advances, and even if the Copyright Owners' proposal was understood to be limited to cases where splits had been resolved, it ultimately appears from Mr. Pedecine's testimony that the proposed late fee would apply to at least some cases where advances are paid. 5/19/08 Tr. 7074:17-7077:16, 7079:6-7080:3 (describing circumstances where late payments on licensed works would be covered by advances), 7090:5-7 (indicating that advances are available to be recouped against late payments).

542. Certainly the data presented by Mr. Pedecine does not provide a reliable basis on which to judge the extent of late payments not covered by advances. The Copyright Owners in their Proposed Findings of Fact recite the same statistics contained in Mr. Pedecine's written testimony. CO PFF ¶ 845. However, that testimony is highly misleading, as explained in RIAA's Proposed Findings of Fact. *See* RIAA PFF ¶¶ 1806-08.

543. The Copyright Owners point to HFA's audit recoveries as justification for a late fee. However, they amount to only about 6.2% of HFA's receipts over the period. CO PFF

¶ 846. That is not much more than half of the percentage that would be required to shift the costs of an audit under the regulations this Court has adopted for Section 114. 37 C.F.R. § 380.7(g), 382.15(g). Moreover, publishers often make unreasonable demands for royalties during audit processes that can last for years. A. Finkelstein WRT at 26, RIAA Trial Ex. 84. In any event, a settlement of such claims that is finally reached is not a reliable indicator of the actual liability. *Cf.* Fed. R. Evid. 408 (settlements not admissible to prove disputed claims).

544. The Copyright Owners point to record company contracts to support their request for a late fee, but those contracts are irrelevant, and paint a mixed picture in any event. They are irrelevant because if the purpose of considering them is as an indicator of marketplace practice, the relevant comparator is marketplace practice with respect to mechanical licenses. The evidence shows that mechanical licenses do not generally contain late fee provisions. RIAA PFF Section IX.C.1.a. The Copyright Owners seem to agree. CO PFF Section XI.5(f) (Terms). Record company contracts paint a mixed picture because record companies do not typically include late fee provisions in artist contracts. 2/14/08 Tr. 3256:10-11 (C. Finkelstein).

545. Finally, the Copyright Owners admit that they have a right to terminate compulsory licenses for late payment, but argue that they should have other remedies as well. CO PFF Section IX.5(d) (Terms). Where Congress has specifically addressed the Copyright Owners' remedies for late payments, this Court should proceed with extreme caution in second-guessing Congress's judgment as to which remedies should apply. The Copyright Owners' unwillingness to invoke the remedies Congress has given them is an insufficient basis to invent new remedies. *See* RIAA PFF ¶¶ 1814-16.

2. Assessment on All-In Transactions

546. The first sentence of the Copyright Owners' Proposed Findings of Fact addressing all-in distribution, or what they refer to as "pass-through licensing" says it all: "Section 115(c)(3)(A) permits a compulsory licensee to authorize the distribution of a musical work by means of a digital transmission." CO PFF ¶ 861. Notwithstanding that Congress chose to permit this practice, and that it is in fact the dominant mode of distributing DPDs, the Copyright Owners want this Court to assess a tax designed to discourage the practice by allowing the Copyright Owners to receive a royalty rate higher than that which this Court otherwise finds reasonable by application of the Section 801(b)(1) objectives. Because this tax flies in the face of Congress's express decision to allow record companies to assume responsibility for mechanical licensing for the DPDs they sell through services, and because the Copyright Owners have not even attempted to justify this further rate increase under the Section 801(b)(1) objectives, this proposal must fail.

547. Nor is there a sufficient evidentiary basis for this proposal. To the contrary, resistance in the marketplace has precluded HFA from including it in its voluntary license agreements. 5/19/08 Tr. 7104:7-7105:21 (Pedecine). It cannot be the goal of this proceeding to give HFA leverage to obtain in its private contracts provisions that HFA has previously been unable to obtain in the marketplace.

548. The Copyright Owners seek to justify their proposed assessment on two grounds. First, they argue that record companies' assuming responsibility for mechanical licensing for the DPDs they sell through services precludes the Copyright Owners from auditing services, which they suggest might be allowing underpayment to go undetected. CO PFF ¶ 862. However, this asserted problem is inherent in Congress's decision to allow record companies to assume responsibility for mechanical licensing for the DPDs they sell through services. As Chief Judge Sledge observed, "it seems to me that what you're doing is raising an objection to the statutory

provision, and you're sad that the statute permits the labels to do this and, because the statute does permit them to do this, then you're seeking some additional revenue as a result of that." 5/19/08 Tr. 7107:5-11 (Pedecine).

549. The Copyright Owners also have made absolutely no effort to quantify whether they have lost income as a result of record companies' selling DPDs on an all-in basis. Record companies are in a position to audit services and have every motivation to ensure that services are not under-reporting usage. CO Trial Ex. 90 at 14-16 (audit provisions in Digital Download Agreement between SONY BMG and Apple); CO Trial Ex. 91 at 10-11 (same for EMI Music and Apple); CO Trial Ex. 92 at DIMA_2006-3_CRB_DPRA003782-83 (same for Warner Music Group and Apple); CO Trial Ex. 93 at DIMA_2006-3_DPRA003702-03 (same for Universal Music Group and Apple). In fact, Bruce Benson described the auditing programs his firm has implemented on behalf of record companies. 5/8/08 Tr. 5610:17-5612:5 (Benson). Nothing in the record establishes that there has been any underreporting by services at all, let alone 3% rather than 1% or some other number. Because this Court cannot adopt an arbitrary assessment in an amount having no basis in the record, the Copyright Owners' purported audit justification for their assessment must fail.

550. Second, the Copyright Owners seek to justify their proposed assessment based on late payment. In this respect, the assessment is cumulative with the Copyright Owners' proposed late fee. Adopting both of these proposals plainly would give the Copyright Owners more than a double recovery, but in fact neither is justified. RIAA PFF ¶ 1820.

551. The Copyright Owners' assertion that "record companies" treat the DPDs they sell during the last month of a quarter as distributed during the following quarter, thereby delaying payment by a quarter, finds scant support in the record. CO PFF ¶ 864. As an initial

matter, this issue arises only under HFA agreements. The compulsory license has a monthly payment cycle, not a quarterly one. Even if the purported problem exists, which is by no means clear, a problem arising from a quarterly payment cycle in *private contracts* cannot be fixed in a proceeding to set terms for a *compulsory license* with a monthly payment cycle. Moreover, the record shows that this assertion is based on only "a couple" audits of unspecified record companies. 5/19/08 Tr. 7050:19-7051:2 (Pedecine). *See* RIAA PFF ¶ 1819. There is no evidence of whether this practice exists beyond those two unnamed examples. Finally, even if this practice were widespread, it is asserted to result in a delay in payment for only one month out of three. That cannot justify an assessment on mechanical royalties for all all-in sales.

3. Attorneys' Fees

552. The Copyright Owners provide no factual justification for their attorneys' fees proposal except the bald assertion that it would "provide an additional incentive for licensees to pay in a timely manner." CO PFF ¶ 866. No reliable evidence establishes that late payment is a significant problem, or that other remedies available to the Copyright Owners provide insufficient means to address late payment. In fact, the evidence is to the contrary. RIAA PFF ¶¶ 1805-1813. The mere fact that the Copyright Owners would like this particular incentive to be enshrined in regulations is an insufficient reason for this Court to adopt it.

553. The Copyright Owners go out of their way to argue that Section 505 of the Copyright Act, which permits a court to award attorneys' fees to prevailing parties in copyright actions, does not give them the remedy they want. CO PFF ¶ 866. It appears that they want this Court to create a new cause of action that Congress has not seen fit to create, and then provide that a Copyright Owner prevailing in this new cause of action should have the benefit of a rare deviation from the American rule that litigants bear their own attorneys' fees. *See Alyeska*

Pipeline Service Co. v. Wilderness Society, 421 U.S. 240 (1975) (only Congress, not the courts, may create exceptions to the rule that each party generally must pay its own attorneys' fees). Plainly Congress's grant to this Court of the power to adopt certain terms of royalty payment does not allow it to grant this sweeping request.

4. Licensing and Reporting Requirements

554. The Copyright Owners say that they are proposing a requirement of greater specificity in licensing and reporting. CO PFF ¶ 868.

555. With respect to licensing, as RIAA has described elsewhere, this Court has no power to change the requirements for obtaining a compulsory license. RIAA COL ¶¶ 262-263.

556. With respect to reporting, the language of the Copyright Owners' proposal appears to differ from the existing regulations only in requiring that in the case of something referred to as a "pass-through arrangement[]" the record company must report "the retail outlet through which the distribution was made to the end user." CO Amended Rate & Terms Proposal Section III.5. The proposal does not define what is meant by a pass-through arrangement. Arguably the language is broad enough to encompass physical distribution. However, record companies have sold physical products for a century through thousands of retailers without being required to report the names of the retailers. The Copyright Owners have provided no evidence or explanation justifying identification in statements of account of every retail store that sells CDs (to the extent that they are even known to record companies). Any such additional reporting "seems unnecessary and burdensome." A. Finkelstein WRT at 14, RIAA Trial Ex. 84.

557. Even assuming that the proposed reference to pass-through arrangements refers only to the case where a record company is the compulsory licensee and sells DPDs on an all-in basis, the Copyright Owners have established no reason why operation of the compulsory license

would be enhanced by reporting the identities of the hundreds of online retailers that resell various kinds of products. The Copyright Owners suggest that perhaps it would facilitate auditing. CO PFF ¶ 868. However, they provide no explanation of why this is so. That is too slim a reed on which to base a departure from long-established reporting requirements.

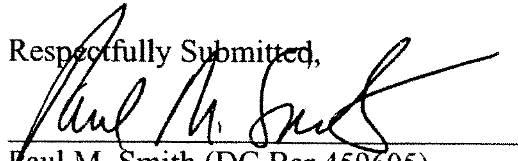
D. The Copyright Owners' Attempt to Overturn the Register of Copyrights on the Referral Questions Regarding Ringtones Must Fail Because Ringtones Fall Squarely Within the Scope of the Statutory License.

558. Notwithstanding the Memorandum Opinion issued on October 16, 2006 by the Register of Copyrights, the Copyright Owners presented testimony at trial and have proposed findings of fact suggesting that ringtones fall outside the scope of the statutory license. *See* CO PFF Section XVII. As has already been explained, the Register concluded in its Memorandum Opinion that "[r]ingtones that are merely excerpts of a preexisting sound recording fall squarely within the scope of the statutory license . . . ." Register of Copyrights, Memorandum Opinion at 3 (Oct. 16, 2006). The Copyright Owners may not seek to have the Judges overturn that decision here. *See* RIAA PFF Section VII.C. The Judges should thus reject the Copyright Owners' proposed findings on this point.

IX. CONCLUSION

559. For the reasons set forth above and in RIAA's Reply Conclusions of Law, as well as the reasons set forth in RIAA's initial Proposed Findings of Fact and Conclusions of Law, the Court should adopt RIAA's proposed Rates and Terms and reject the Rates and Terms offered by the Copyright Owners.

Respectfully Submitted,



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