

TESTIMONY OF

MICHAEL POLLACK

Before the
COPYRIGHT ROYALTY BOARD
Washington, D.C.

QUALIFICATIONS

My name is Michael Pollack. Today I am enjoying retirement after a 31-year career in the recording industry. My last position before retirement was Senior Vice President, Legal at the Atlantic Records Group, from 2004 to 2005. Prior to that I was Senior Vice President, General Counsel of the Elektra Entertainment Group, from 1995 until 2004, when it merged with Atlantic Records to form the Atlantic Records Group. Before that I was Vice President, Senior Counsel at Sony Music from 1992 to 1995; Vice President, General Counsel at Arista Records from 1979 to 1991; and Assistant General Attorney at CBS Records from 1974 to 1979. I began my career in the entertainment field with six years as an attorney for companies in the motion picture industry. I was also President of The Copyright Society of the U.S.A. from 1998 to 2000. I graduated from New York University in 1964 and received my law degree from Harvard Law School in 1967.

I served on RIAA's Legal Committee from 1975 to 2004. As a member of the Legal Committee, I represented my employers' interests with respect to the full range of legal questions affecting the recording industry and being addressed by RIAA. I was also a member of RIAA's Mechanical Royalty Task Force during the industry negotiations of mechanical royalty rates leading to settlements thereof in 1987 and 1997. The Mechanical Royalty Task Force, which was composed of representatives of all the major record companies, determined RIAA's negotiating positions and strategy for both negotiations.

I have many friends who are still employed in the recording industry and am generally aware of industry conditions today.

SUMMARY

The purpose of my testimony is to describe business conditions in the recording industry in the 1980s and 1990s and the settlements that led to the current statutory mechanical royalty rate. From that description, several points should be clear:

The condition of the recording industry today is very different from any time in the past when mechanical royalty rates were determined. The industry has always been somewhat cyclical, with the number and size of hits varying from company to company year to year, new formats being introduced, old formats in decline, and corresponding short-term shifts in record prices and sales. The industry has also always felt the bite of piracy. However, until the last six years of my career, about 1999, the general trajectory of the industry was always upward – bigger hits, higher sales, and higher prices. Since then, the whole recording industry has contracted in a way that is unprecedented. This is a sea change, not a short-term fluctuation. And this transformation of the industry is still continuing.

When we negotiated mechanical royalty rate settlements in 1987 and 1997, we did our best to hold the line on increases in mechanical royalty payments as a percentage of wholesale revenues. In determining our negotiating positions, we always tried to limit growth in mechanical royalty payments in relation to record company revenues from our wholesale customers, because the effect of such payments on our margins is our dominant business consideration in the setting of rates. We were always concerned when mechanical rates, as a percentage of wholesale prices, had crept upward, and always sought to maintain a balance. In both 1987 and 1997, we reached agreements that we believed would limit or reverse such growth in mechanical royalty rates as a percentage of wholesale prices.

Mechanical royalty rates today are at an all-time high because of reasonable assumptions we made that did not hold true. In 1987 and 1997 we did our best to make reasonable

assumptions about the industry's future performance. The assumptions we made in 1987 were somewhat inaccurate. The assumptions we made in 1997 proved wildly inaccurate, largely due to unexpected and unprecedented peer-to-peer and physical product piracy that has savaged the industry, as well as unexpected changes in the retail environment. As a result, the mechanical rate as a percentage of average record company wholesale price has today reached a level that is way out of line with historical and international levels and to which we would not have agreed had we known how events would unfold.

Only a percentage-of-wholesale-revenues rate structure can maintain a balance between mechanical royalty payments and wholesale revenues over time, particularly in an uncertain business environment such as today's. Nobody's crystal ball is clear enough to predict with precision the trends in all the variables relevant to maintaining a fair cents-based mechanical royalty rate over a five or ten year period. Twenty-five years of trying to approximate a percentage rate with a cents rate is enough. The only way to ensure that mechanical royalty payments will remain fair is with a percentage rate applied to wholesale revenues.

Because the 1987 and 1997 settlements were predicated on not being used as precedent in litigation or any rate adjustment proceeding, they are useful only to understand how the current rates got out of line from where they originally were. When we negotiated each agreement, we were concerned that our projections about future industry conditions might prove inaccurate. When presented with the opportunity to avoid litigation by reaching an agreement on rates that we believed would probably result in little or no increase, or perhaps a decrease, in mechanical payments as a percentage of wholesale revenues, we did so. However, we relied on the express understanding that they would not be used as precedent in litigation or any rate adjustment proceeding. It would repudiate those understandings and not be fair to infer from the fact of our

1987 and 1997 agreements that we were happy with the rates that applied at the time of the negotiations. It would be flatly wrong to infer that record companies at any point would have accepted today's rates based on today's industry economic conditions. However, it is important to understand these settlements as historical markers illustrating that today's rates are out of line.

DISCUSSION

I. 1980-1987

A. Industry Conditions in General

The beginning of the transition to the CD format defined the recording industry in the period 1980-1987. The CD standard was adopted in 1980, and the first commercial music CDs were released in 1982. It is impossible to predict the penetration rate of a new format with precision, and thus it took a while before it was clear that the CD would become a successful format. In the 1970s, we had seen the failure of a number of different formats, including quadraphonic sound, which offered multi-channel audio from vinyl records, eight tracks, or reel-to-reel tapes. After a significant number of recordings were made in these new formats, each one failed to take hold (at great expense to record companies). In the case of the CD, sales started small, but increased rapidly year to year.

Heading into the 1987 mechanical rate proceeding, there were grounds for optimism. Not only did it look like the CD was going to be a success, but cassette tapes were also growing in popularity, and far exceeded CD sales. And while vinyl was well into its decline, LPs and singles were still popular and selling well.

Moreover, while we were concerned about the impact of piracy on our business, the problem was not nearly as large, and we were not spending nearly as much on antipiracy efforts, as record companies do today. We considered high speed duplication of cassettes to be a large problem at that time, but it was insignificant compared to the online piracy on peer-to-peer file-

sharing networks and widespread CD burning that would soon become prevalent. CD piracy was quite rare at the time, because it was only possible for pirated copies to be made in CD plants. Because the CD format was reasonably secure, we believed that piracy would not be a major issue for record companies in the coming years.

B. 1987 Mechanical Royalty Rate Settlement Discussions and Agreement

We began to discuss mechanical royalty rates with the music publishers in 1986. At that time, the mechanical royalty rate had just increased to five cents pursuant to the schedule of rate increases adopted in 1981. Despite the Copyright Royalty Tribunal's intention that mechanical royalty rates maintain parity with retail list prices of records, since 1981, mechanical royalty rates had increased much faster than both retail list prices and wholesale prices. This meant that the mechanical rate had increased not only in cents, but also as a percentage of our wholesale prices. We thought the rate was too high.

However, the 1981 Copyright Royalty Tribunal proceeding was still fresh in our memory, and we were reluctant to incur the expense and risk of a litigated proceeding again so soon. In addition, record companies, publishers, artists and writers need to work together every day. The 1980-1981 proceeding was very divisive in the music industry. To avoid litigation, we welcomed the possibility of reaching an agreement with the publishers, if we could reach a deal that we thought would probably maintain parity between mechanical royalty rates and our wholesale prices over time.

The centerpiece of the publishers' negotiating position was that rates should be adjusted in proportion to changes in the Consumer Price Index ("CPI"). The National Music Publishers' Association ("NMPA") first proposed that the mechanical royalty rate increase by one cent – to six cents – as of January 1, 1987, with annual CPI-based adjustments after that.

We recognized that the CPI bore no relationship to our wholesale prices. Over the previous decade, it had risen much faster than LP and cassette tape wholesale prices, and CD wholesale prices had fallen in the first years after their introduction. Accordingly, we initially rejected the use of the CPI as the basis for rate adjustments. Instead, we suggested an increase in the rate by one-half cent every three years, beginning on January 1, 1989.

However, the publishers held firm in their insistence on CPI-based adjustments. In the final analysis, whether it made sense to do a deal on this basis depended primarily on two considerations: (1) our desire to avoid the costs, risks and divisiveness of litigation, which was considerable, and (2) our assumptions of how CDs would be priced over the next ten years and how quickly CDs would displace sales of other formats.

We recognized that predicting CD prices and the pace of CD penetration over ten years was an uncertain enterprise, but by 1986 it appeared that the CD format would be a success, and it seemed clear that the market would bear a CD price significantly higher than prices of cassettes and LPs. We finally concluded that over ten years, our average unit wholesale selling price was likely to increase at almost the same pace as the CPI due to our sales mix becoming more heavily weighted toward higher-priced CDs. Accepting the risk of lower CD prices or slower CD penetration seemed like a reasonable decision to avoid the risk, expense and divisiveness of litigation. We also mitigated our risk of being wrong by agreeing that the settlement would not have precedential effect in future rate proceedings.¹

¹ See Joint Petition for Automatic Adjustments of Mechanical Royalty Rate, at 5 (stating that the joint proposal was "without prejudice to any position, contention, or argument which the Copyright Owners or Copyright Users may take in any proceeding or litigation, and is not intended to be, and should not constitute, a precedent in any rate adjustment proceedings in 1997 or thereafter.") (attached as RIAA Ex. J-101-DP).

Accordingly, the proposal eventually agreed to by NMPA and RIAA, and submitted to the Copyright Office, called for the then-current five-cent royalty rate to be adjusted in proportion to the CPI on January 1, 1988, and then again every two years through 1996, after which another rate-setting proceeding would occur.² The agreement provided that the royalty rate could not go below five cents, and also that it could not increase more than 25% in any single adjustment. Having such a cap was important to us to protect against unpredictable changes in the CPI.

C. 1988-1997

1. Industry Conditions in General

The next decade was generally good for the recording industry, but it had its ups and downs, and mechanical rates as a percentage of record company wholesale prices continued to edge up.

As a result of the 1987 agreement, mechanical royalty rates rose steadily. Following the agreed-upon formula, the rate increased from 5 cents to 5.25 cents in 1988, 5.7 cents in 1990, 6.25 cents in 1992, 6.6 cents in 1994, and 6.95 cents in 1996.³ This represented an average annual increase of 3.4% between 1987 and 1997.

CD prices continued to fall through 1990, and while they then started to climb, they never returned to the level that they were during the 1986-1987 negotiations. Cassette prices went up, but then drifted down, and so had disappointing growth over the decade. But we were right that

² See 52 Fed. Reg. 22,637 (June 15, 1987) (attached as RIAA Ex. J-102-DP).

³ See 52 Fed. Reg. 41,711 (Oct. 30, 1987); 54 Fed. Reg. 46,065-66 (Nov. 1, 1989); 58 Fed. Reg. 58,282 (Nov. 1, 1993), corrected by 58 Fed. Reg. 60,787 (Nov. 18, 1993); 60 Fed. Reg. 55,458 (Nov. 1, 1995) (all attached as RIAA Ex. J-103-DP).

the CD format would be a success. The number of CDs shipped each year climbed sharply, and CDs came to dominate the market.⁴

During this decade, we became increasingly aware of the potential for electronic distribution of music. In 1995, we negotiated with the music publishers the legislation that would become the Digital Performance Right in Sound Recordings Act (“DPRA”), which added the concept of a digital phonorecord delivery (“DPD”) to Section 115. The DPRA also stated that the mechanical royalty rates and terms should distinguish between DPDs in general and “digital phonorecord deliveries where the reproduction or distribution of a phonorecord is incidental to the transmission which constitutes the digital phonorecord delivery”⁵ – so-called “incidental DPDs.” Incidental DPDs were an invention that was necessary to make the DPRA possible, but I do not believe anybody ever understood precisely what they were supposed to be. Whatever they are, from my perspective, the reason for distinguishing them was that they should bear a low mechanical royalty rate because they are incidental.

Also during this decade, piracy of cassettes gave way to piracy of CDs, and recordable CDs (“CD-Rs”) became available, but business was nonetheless good. Not until 1996 did seizures of pirated CDs surpass cassette seizures.⁶ Only at the very end of this period did we get our first taste of Internet piracy – people posting recordings on personal websites and file transfer protocol (“FTP”) sites. In fact, it was not until late 1997 that RIAA hired its first employee focusing primarily on Internet piracy.

⁴ See The Recording Industry Association of America’s 2000 Yearend Statistics (attached as RIAA Ex. J-104-DP).

⁵ 17 U.S.C. § 115(c)(3)(C), (D)(attached as RIAA Ex. J-105-DP).

⁶ See RIAA Press Release, “Recording Industry Releases 1996 Anti-Piracy Report,” March 12, 1997 (attached as RIAA Ex. J-106-DP).

D. 1997 Mechanical Royalty Rate Settlement Discussions and Agreement

As we entered the next round of mechanical royalty negotiations with the publishers in 1996, weighted average wholesale prices had increased at about the same pace as the statutory rate due to rapid CD penetration over the previous ten years. However, pressure from artists and a need to give consumers value commensurate with higher CD prices forced us to include more tracks on each album. Taking that into account, our aggregate mechanical royalty payments as a percentage of wholesale revenues had increased.

Going forward, we knew that we could no longer count on the transition from less expensive cassettes to more expensive CDs to produce significant increases in our weighted average album wholesale price. Two primary goals of the record companies in this negotiation were (1) in the absence of a marketplace for DPDs, to address general and incidental DPDs in a way that would not prejudice our ability to introduce new types of service offerings in the years to come, and (2) to reduce rates, or at least maintain rates, as a percentage of the wholesale price by having rate increases lag, or at least track, increases in wholesale prices.

It was simply too early in the development of the online marketplace for either record companies or publishers to make informed business judgments about DPD mechanical royalty rates. I do not recall that any commercially significant legitimate online music service had been launched. As a result, we did not know what sort of services might develop or what prices consumers might be willing to pay for those services. The DPRA, enacted in 1995, had set the statutory mechanical rate for DPDs before 1998 at the physical rate,⁷ and provided that that arrangement was not to be precedential.⁸ A year later, we had no better information on which to

⁷ 17 U.S.C. § 115(c)(3)(A)(i) (attached as RIAA Ex. J-105-DP).

⁸ 17 U.S.C. § 115(c)(3)(D) (attached as RIAA Ex. J-105-DP).

base DPD mechanical rates, so RIAA and NMPA agreed early in our negotiations that the DPD rate should remain tied to the physical rate for the time being.⁹ That agreement was subject to two very important premises: (1) as in the case of the original interim arrangement provided in the DPRA, the tying of DPD rates to physical rates would be nonprecedential,¹⁰ and (2) this arrangement could be revisited every two years.¹¹

As to physical formats, the publishers' opening position was to continue the existing system of mechanical royalty rate determination for another ten years, so that there would be an adjustment every two years based on the CPI. However, because it was very important to us to have increases in the mechanical royalty rate maintain parity with increases in wholesale prices, and understanding that we would not have CD penetration to drive increases in our wholesale prices, we refused to use the CPI again. We researched and suggested alternate indices that could be used to establish a royalty rate linked to wholesale prices, but were eventually unable to agree on an appropriate inflation-based index that would reflect wholesale record prices.

During this negotiation, we also believed that the rate in the U.S. should be lower than the rate applied in other countries, because the U.S. market is the largest market in the world, and U.S. record companies export a great deal of recorded music. That means that production of recordings in the U.S. not only tends to generate greater domestic mechanical, performance, and synchronization income for songwriters and publishers than does production of recordings

⁹ See 37 C.F.R. § 255.5 (attached as RIAA Ex. J-107-DP); Proposal Concerning 1997 Physical Phonorecord and Digital Phonorecord Delivery Royalty Rate Adjustments (submitted with Joint Petition for Adjustment of Physical Phonorecord and Digital Phonorecord Delivery Royalty Rates) at ¶ 4 (attached as RIAA Ex. J-108-DP).

¹⁰ *Id.*

¹¹ See 37 C.F.R. § 255.7 (attached as RIAA Ex. J-109-DP); Amended Proposal Concerning Digital Phonorecord Delivery Royalty Rate Adjustments (submitted with Amended Joint Petition for Adjustment of Digital Phonorecord Delivery Royalty Rates) at ¶ 3 (attached as RIAA Ex. J-110-DP).

elsewhere, but also tends to lead to foreign mechanical, performance, and synchronization royalty income. Looking at growth in the U.S. mechanical royalty rate relative to international rates reinforced our belief that the U.S. mechanical royalty rate had become too high and should not continue to increase at the same rate in coming years.

Eventually, to avoid the costs, risk and divisiveness of litigation, we agreed to a series of fixed increases in royalty rates every two years. Under the agreement, the rate increased from 6.95 cents per song to 7.1 cents in 1998, 7.55 cents in 2000, 8.0 cents in 2002, 8.5 cents in 2004, and 9.1 cents in 2006.¹²

We believed that this agreement would maintain balance in mechanical royalties, based on projections that the mechanical royalty rate would increase at or below the pace of the increase in our wholesale prices. Looking backward, we knew that between 1986 and 1996, the statutory mechanical royalty rate had increased annually by an average of 3.4%. The 1997 agreement included only a 2% increase in 1998, and slowed growth over the ten-year rate period to a much lower average annual rate of 2.7%. We calculated that if wholesale prices continued to increase at a pace similar to that of the period from 1985 to 1995, our average mechanical royalty payments over the next ten-year period would be lower, as a percentage of wholesale revenues, than our mechanical royalty payments at the time of our negotiations. We believed this was a reasonable assumption. And if wholesale prices increased more quickly in the next ten years, mechanical royalty rates would drop even lower as a percentage of wholesale prices. Moreover, because rate increases no longer would be pegged to the CPI, the 1997 agreement eliminated uncertainty over future royalty rates.

¹² See 37 C.F.R. § 255.3 (attached as RIAA Ex. J-111-DP); Proposal Concerning 1997 Physical Phonorecord and Digital Phonorecord Delivery Royalty Rate Adjustment at ¶ 1 (attached as RIAA Ex. J-108-DP).

Once again, we mitigated our risk of basing our agreement on inaccurate assumptions by agreeing that the settlement would not have a precedential effect in future rate proceedings.¹³

E. Recording Industry Conditions, 1998-2006

While the assumptions on which we based our 1997 agreement seemed perfectly reasonable at the time, market conditions turned out very differently. We simply did not see the magnitude of online piracy coming. The original Napster launched in the summer of 1999, and by the next year, copyright infringement through peer-to-peer file-sharing services exploded. Physical piracy through CD ripping and burning also became much more common around the same time, as CD drives with the capability to perform those operations became more common and inexpensive. As a result of piracy and other factors, there has been a dramatic decline in industry sales and revenue since 1999, as described in the testimony of David Teece. Average wholesale prices continued to rise until 2003, but faced with falling sales, impossible competition from peer-to-peer services that gave our music away for free, and a challenging retail environment, including the closure of many traditional music retail outlets, prices have fallen steadily since then. This is not a minor year-to-year fluctuation, but a long term trend that has already caused a dramatic restructuring of the industry (including the merger of my former label, Elektra, into Atlantic).

The digital marketplace that emerged after 1997 was unlike any previous successful launch of a new format. When cassette tapes began to replace LPs, and CDs began to replace LPs and cassette tapes, we sold a lot of records to people who were re-buying in the new format music they already owned in an old format, and our margins on the new formats were good.

¹³ See Joint Petition for Adjustment of Physical Phonorecord and Digital Phonorecord Delivery Royalty Rates at 3 (attached as RIAA Ex. J-108-DP); Amended Joint Petition for Adjustment of Digital Phonorecord Delivery Royalty Rates at 3 (attached as RIAA Ex. J-110-DP).

Today, people are not buying downloads of music that they own in other formats. If they want electronic copies of music they own, they are ripping their CDs. Or even worse, they are taking music for free by downloading it illegally from peer-to-peer services or getting burned copies from others. And sales of relatively expensive albums are giving way to sales of relatively inexpensive single downloads, which is creating pressure on record company margins. These conditions, coupled with the DPRA's making rate formulations contained in controlled composition clauses in artists' recording contracts inapplicable to DPDs,¹⁴ has meant that the current 9.1 cent statutory rate is 13% of a 70 cent download wholesale price, and an even higher percentage of the wholesale price of an album download. Thus, the economic results created by the current statutory rates are way out of line with historical and international levels – including the economic results we thought we were agreeing to in 1987 and 1997.

CONCLUSION

Both the 1987 and 1997 settlement agreements were based on reasonable assumptions that over the next ten years – an eternity in a dynamic marketplace – business trends in the recording industry would continue like they had in the recent past. They were also entered into with the assurance they would not constitute precedent in future rate-setting proceedings. In both instances the record companies thought we were agreeing to rates that would be equitable in the following years. However, both times industry conditions turned out differently than we projected. In particular, we never could have predicted the sea change that has taken place since 1999. As a result, rates today are badly out of line with historical and international levels.

¹⁴ I understand that Cary Sherman will testify that controlled composition clauses are provisions in artists' and producers' agreements with record companies that typically grant the record company a mechanical license with respect to songs written and recorded by the artist or producer, as well as related rights such as the ability to use those songs in music videos.

The only way to ensure that mechanical royalty rates will maintain balance with wholesale prices over time is with a percentage rate. Having twice participated in the settlement of mechanical rates based on projections of prices and sales that proved inaccurate, I have a keen appreciation of how difficult it is to predict prices and sales over the long term with the confidence necessary if one is to have a cents rate and expect it to do justice. I just do not think it is possible in today's environment, in which the business of selling recorded music continues to deteriorate, and which is far more uncertain than the generally good years that characterized most of the time I was privileged to work in the recording industry.

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

Michael Pollack
Michael Pollack

Date: November 27, 2006

Exhibits Sponsored by Michael Pollack (Public)

Exhibit Number	Description
J-101-DP	Joint Petition for Automatic Adjustments of Mechanical Royalty Rate
J-102-DP	52 Fed. Reg. 22,637 (June 15, 1987)
J-103-DP	52 Fed. Reg. 41,711 (Oct. 30, 1987); 54 Fed. Reg. 46,065-66 (Nov. 1, 1989); 58 Fed. Reg. 58,282 (Nov. 1, 1993), <i>corrected by</i> 58 Fed. Reg. 60,787 (Nov. 18, 1993); 60 Fed. Reg. 55,458 (Nov. 1, 1995)
J-104-DP	The Recording Industry Association of America's 2000 Yearend Statistics
J-105-DP	17 U.S.C. § 115
J-106-DP	RIAA Press Release, "Recording Industry Releases 1996 Anti-Piracy Report," March 12, 1997
J-107-DP	37 C.F.R. § 255.5
J-108-DP	Joint Petition for Adjustment of Physical Phonorecord and Digital Phonorecord Delivery Royalty Rates (with attached Proposal Concerning 1997 Physical Phonorecord and Digital Phonorecord Delivery Royalty Rate Adjustment)
J-109-DP	37 C.F.R. § 255.7
J-110-DP	Amended Joint Petition for Adjustment of Digital Phonorecord Delivery Royalty Rates (with attached Amended Proposal Concerning Digital Phonorecord Delivery Royalty Rate Adjustment)
J-111-DP	37 C.F.R. § 255.3