SONY BMG
MUSIC ENTERTAINMENT

550 Madison Avenue . New York . NY . 10022-3211 . 212.833.8000

TESTIMONY OF

RON WILCOX

Executive Vice President and
Chief Business and Legal Affairs Officer

SONY BMG MUSIC ENTERTAINMENT

New York, NY

Before the
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Washington, D.C.

QUALIFICATIONS

My name is Ron Wilcox, and I am the Executive Vice President and Chief Business and Legal Affairs Officer of SONY BMG MUSIC ENTERTAINMENT. In that position, I oversee all of SONY BMG's Business and Legal Affairs activities, including negotiating deals with artists, music publishers, and digital music services and formulation of policies concerning new technologies and other matters.

I have worked in the music business for almost 25 years. Prior to Sony's merger with BMG, I was Executive Vice President, Business Affairs and New Technology at Sony Music Entertainment. Between 1990 and 2000, I was Senior Vice President, Business Affairs & Administration at Sony Music. From 1983 to 1990, I worked in Business Affairs for CBS Records. Previously, I was an attorney for CBS Inc.

I graduated from the College of Wooster in 1975 and the University of Michigan Law School in 1978.

INTRODUCTION AND SUMMARY

Record companies like SONY BMG are the driving force of the music industry. It is record companies that turn the notes and lyrics of songs – or often just an idea for a song – into a high-quality commercial product, connect it with an audience, and distribute it through every practicable means. The creative contribution and investment made by record companies are what makes it possible for songwriters and publishers to make money from songs.

The music marketplace is undergoing fundamental and permanent changes. Historically, record companies sold basically one product – physical copies of recordings. Even when new formats such as the CD were introduced, change was evolutionary. The basic business model and distribution channels of the industry remained essentially unchanged. Today, the old physical sales model is in decline. The future of the recording industry lies primarily in new channels of distribution and new product and service offerings made possible by an explosion of transformative technologies and non-traditional channels of distribution. We are working every day to bring about that future by making possible distribution of music through every available channel, although new media products are unlikely to make up the decline in traditional physical product sales during the next statutory royalty rate period.

Record companies and their technology partners have created a wide array of new products and services and developed innovative new marketing strategies. We have created new business models and agreements to form the basis of the emerging digital marketplace. All of this has required high capital investments and clearing enormous licensing and consumer acceptance hurdles. Music publishers do not make such investments. Indeed, music publishers have relied upon Section 115's inflexible rate structure and uncertainty concerning how new types of offerings fit into that rate structure to resist our efforts to launch new products and services, even though they and their clients would stand to make more money if these new products and services succeed in the marketplace.

SONY BMG led the industry with a business innovation to unlock storehouses of musical works and make them available to consumers in a range of new product and service offerings. These so-called "New Digital Media Agreements" or "NDMAs" served the very important purpose of allowing us quickly to enter the marketplace with a wide selection of repertoire in a range of new formats. However, these NDMAs were not meant to set a rate precedent and should not be used as a benchmark in this proceeding. The NDMAs represent an intricate and heavily negotiated package of rights and rates that go beyond the scope of Section 115. We entered into these agreements out of necessity, and made significant compromises during the negotiations to enable the timely release of new and innovative products. For the reasons more fully set forth below, the rates set in an NDMA for any particular type of product should not be relied upon in setting rates in this proceeding.

Going forward, we need a mechanical royalty rate structure and rate that will allow us to continue to innovate and make progress in defining the new music marketplace. A percentage rate would be most appropriate. A percentage royalty is the only way to cover all forms of phonorecord distribution in the marketplace today and that may be developed in the next five years. It is also the only fair way to address uncertainty concerning pricing and variations among prices for different types of offerings in the marketplace. A percentage royalty would allow artistic considerations and consumer demands to shape the form of future products without the constraints of an inflexible "cents rate" royalty. A percentage royalty would allow entry into new and experimental markets by reducing the investment required and risk undertaken while at the same time allowing publishers to share in our success if those markets are successful.

We also need a mechanical rate that reflects the overwhelming contributions and investments of record companies and the risks and uncertainty of today's marketplace conditions. I have reviewed and support RIAA's rate proposal in this proceeding. I believe that adopting it would contribute significantly to the ability of record companies to expand the music business, to the betterment of everyone in the music value chain.

In my testimony, I first provide some background concerning SONY BMG. Second, I briefly describe current industry conditions and why they compel us to move aggressively to use a wide variety of new technologies to make our creative works available to the public. Third, I describe the incredible diversity of the emerging digital marketplace and the contributions of record companies to its development. Fourth, I describe some of the difficulties we have had obtaining rights to distribute musical works in new ways despite Section 115's compulsory license, and how we made progress in addressing those problems with our NDMAs. Finally, I describe why we need a percentage rate structure, and a rate lower than today's, to complete the transition to the music marketplace of the future.

DISCUSSION

I. Background Concerning SONY BMG

SONY BMG is a global recorded music joint venture that was formed in August 2004. It is 50% owned by Bertelsmann AG and 50% owned by Sony Corporation of America. SONY BMG encompasses some of the most influential and successful record labels in the world, which are home to a wide array of both local and international artists, including Arista (Whitney Houston, Sarah McLachlan and Santana); Columbia Records (Aerosmith, Tony Bennett, Beyonce, Bob Dylan, Destiny's Child, Dixie Chicks, Bruce Springsteen and Barbra Streisand); Epic Records (Incubus, Los Lonely Boys and Jennifer Lopez); Jive (R. Kelly, Britney Spears and Justin Timberlake); J Records (Alicia Keys, Annie Lennox and Rod Stewart); LaFace (OutKast, Pink and Usher); RCA Records (Christina Aguilera, Dave Matthews Band and Avril Lavigne); SONY BMG Nashville (Kenny Chesney, Alan Jackson, Martina McBride, Travis Tritt and Gretchen Wilson); Masterworks (Yo-Yo Ma, Joshua Bell and The Five Browns); SONY BMG UK (Il Divo, Oasis, Sade, Westlife and Will Young); SONY BMG Japan (Kazumasa Oda); SONY BMG Italy (Eros Ramazzotti); SONY BMG Australia (Human Nature, Delta Goodrem); and over 40 other SONY BMG international companies, which are home to such major artists as Celine Dion, Julio Iglasias, Leonard Cohen, Ricky Martin, Ricardo Arajona, Roberto Carlos, Jay Chang, Coco Lee, Lordi, Pascal Obispo, and La Oreja de Van Gogh.

In addition, SONY BMG is home to a broad array of catalog recordings, including masterworks from such all-time greats as Miles Davis, The Byrds, John Denver, Johnny Cash, Frank Sinatra, Rosemary Clooney, Bing Crosby, Benny Goodman, Al Jolson, Janis Joplin, Louis

Armstrong, Dolly Parton, Elvis Presley, Vladimir Horowitz, Glenn Gould and Stevie Ray Vaughan.

II. <u>Industry Conditions</u>

Since 1999, the recording industry has been hit by a "perfect storm" - a confluence of business conditions that have created intense pressure on margins and caused a contraction in the business that is unprecedented in its history, including:

- Piracy – In the late 1990s, music began to be distributed over the Internet – usually illegally - and at the same time, CD ripping and burning technology became widespread and easy to use. Almost overnight it became easy for anyone with a computer to get a perfect digital copy of almost any recording ever made for free, burn it to a CD, and redistribute it electronically or in physical form. Today, we estimate that more permanent copies of recorded music are acquired illegally than legally.
- Harsh retail environment – Specialty record stores have closed, including, most recently, Tower Records. In their place, "big box" retailers like Wal-Mart, Target, and Best Buy have emerged as SONY BMG's largest retail accounts. Well over [redacted]% of SONY BMG's physical album sales in 2005 were through big box retailers. Our sales through specialty record stores are considerably lower. During the first half of 2006, our sales through Transworld, the largest owner of traditional record stores, including such widely-known chains as Sam Goody's, FYE, and Coconuts, were only about [redacted]% of our combined sales through Wal-Mart, Target and Best Buy. Large retailers today carry less selection, cutting into sales of older "catalog" releases; sell music at deep discounts; and insist upon deep discounts at wholesale. In addition, to get any kind of preferred placement in the store or its advertising, we have to pay for it (so-called "coop advertising" payments).

- Radio consolidation – Huge broadcasting companies have bought up radio stations and narrowed and homogenized their playlists. Fewer new recordings get significant airplay, and disc jockeys seldom talk up the songs they play. As a result, we are losing whatever benefits are available in marketing on the radio through the constant repetition of music to a mass audience in a particular geographic community. To compensate we have had to increase our marketing expenses and overhead significantly.
- Declining physical formats – CD sales are falling fast, and likely will decline at a rate of 10 to 15 percent a year over the period that will be covered by the rate set in this proceeding. As I describe later, we have pushed hard to launch new physical formats, but nothing so far has caught on with consumers. We estimate that by 2009, digital sales will constitute [redacted] of our total global sales. By the end of the next rate period, physical media may be only a niche product.
- Challenges of the Legitimate Digital Marketplace – A legitimate marketplace for electronic distribution of music is emerging and beginning to produce significant revenues ($[redacted] million for SONY BMG in 2005). Distributing music electronically, however, has required new categories of cost and investment well out of proportion to the approximately 8% of overall industry shipment retail value that electronic distribution represented in 2005, or even the approximately 16% it represented in the first half of 2006. Online sales are also cannibalizing CD sales, as consumers buy a download or two priced at 99 cents or less rather than an $18 dollar album. We estimate that only [redacted] online music purchases is of an entire album; the rest are individual track downloads.

- Limited Online Retail Outlets. Apple's iTunes Music Store is by far the most popular online site for downloading songs legally. It accounts for more than 80% of online permanent download sales. Its share of that market segment dwarfs Wal-Mart's share of physical product sales, and like Wal-Mart, Apple exerts considerable downward price pressure. Because of Apple's dominant position in this market segment, three years after the launch of iTunes we are still hard pressed to raise wholesale prices for even a limited number of online downloads. Moreover, to compete with Apple, other competitors in the music download market have set their retail prices below Apple's 99 cent price. For example, Wal-Mart sells downloads for 88 cents on its website.

This confluence of conditions has caused and is continuing to cause intense pressure on our margins, gut-wrenching contraction in the industry, and an unprecedented transformation. Unlike the music publishing business, which has long derived almost all of its revenues from licensing, the revenues of SONY BMG and other record companies historically have derived principally from the distribution of physical products. As described in the testimony of David Teece, there has been a dramatic decline in industry sales and revenue in recent years. Hit records are fewer in number and sell fewer units. The growth of digital music sales, while robust, has not been high enough or fast enough to offset the impact of the decline of physical sales. From 2005 to 2006, our revenues from digital sales increased by about $[redacted] million, but revenues from physical sales fell by about $[redacted] million. Moreover, we must maintain staff and infrastructure to support both digital sales and physical sales, which raises costs further.

Under these circumstances, it is much harder than it used to be to help an artist achieve commercial success. When we do achieve success, artists want to renegotiate their contracts, with the effect of squeezing our margins on their next release. In addition, subsequent releases by artists that have had one hit increasingly do not enjoy the same level of commercial success as they once might have.

We have not stood idly by as these conditions reshaped our business environment. Sony and BMG merged to create SONY BMG, because consolidation provided the best chance to maintain a broad roster of artists and worldwide reach. Over time, we have gone from a combined pre-merger employment in 1999 of approximately [redacted] to about approximately [redacted] employees today, a decrease of about [redacted]%.

We also have recognized for a long time that the future of the recording industry lies in making as many creative works as possible available to the public through new channels of distribution, new product and service offerings and new business models made possible by new technologies, even if such new media products are unlikely to make up the decline in traditional physical product sales during the next five years. We are working every day to make that future real.

III. <u>The Emerging Digital Marketplace</u>

Although adapting to the music industry's changes has been difficult, it is also exciting. We now have a whole new universe of ways to reach consumers with our music and thereby generate revenues for everyone in the music value chain. Our goal is to make as much of our music as possible available to the public in as many ways as we can. Below I discuss the incredible diversity of products and services that record companies and their technology partners are bringing to the marketplace; the creative and technological contributions, investments, cost and risk of record companies and their technology partners in doing so; and the creative ways we are using technology to reach consumers and sell more music.

A. Diversity of Offerings and Business Models

When I began my career in the music industry, record companies sold physical copies of recordings. We had LPs and cassettes, some singles and a few eight-track tapes, and the first CDs were just being released, but the basic business model and distribution channels were all the same. Today, consumers have so many more options of how they can acquire and interact with music, and we have so many more options of how to present and price music to maximize revenues for everyone in the music value chain.

The range of product and service offerings in the marketplace is already incredible, and is only going to become more so. I will describe some current offerings in a moment. However, examples do not really do justice to the full range of what is possible and even foreseeable in the next five years. To get a feel for that it is helpful to understand some of the different dimensions of innovation that make possible this incredible diversity of offerings:

- Content Type – Record companies used to sell audio recordings and give away short-form music videos to promote them. Today we produce many different types of musical and related content, and we try to generate revenue from all of it. With respect to our bread and butter product – audio recordings – we not only produce stereo recordings, but recordings in new high definition stereo and surround sound. We also are producing and selling short-form music videos, concert videos, "making of" documentaries, artist interviews, spoken word recordings, photographs, "wallpaper" for video displays, and more. In addition, if we can find a market for an excerpt of one of our creative works (such as for use as a mastertone), we will distribute products into that market.
- Format – It used to be that every few years we would introduce a different type of physical carrier. However, all of these products were evolutionary. Now we have a

huge range of options of different product and service types at our disposal, and there inevitably will be more. On the physical side, our strategy is to maximize the remaining opportunities in the marketplace for distribution of physical products, including by pursuing new physical product formats. In recent years, we have released products on DVD-Audio disc, Super Audio Compact Disc ("SACD"), DualDisc (a disc with a CD on one side and a DVD on the other), MiniDisc and Universal Media Disk ("UMD"). For example, we spent approximately $[redacted] on efforts to launch DualDisc. These formats have not found traction in the marketplace despite our investment in them, but we are still releasing new CD Extra and CD/DVD combination products. We also are looking at new high definition products such as Blu-Ray, as well as nontraditional formats, such as content preloaded on MP3 players or portable memory (e.g. Memory Stick). With respect to electronic transmission, the basic options are downloads (where the user gets a copy for later playback) and streams (where a work is transmitted in real time for one-time play). However, downloads can be shaped into various kinds of consumer offerings through different usage rules (see below), and streams can reflect greater or lesser degrees of consumer control, from basic pre-programmed transmission (like radio), to playlists personalized to the consumer's preferences, to on-demand transmission of what the consumer wants when he wants it. There also can be "hybrid offerings" with elements of both product and service – such as when a CD is burned at a kiosk in a retail store after a transmission from a central server, or an online retailer sells a CD for delivery by mail but gives the consumer the instant gratification of being able to get the music online while the disc is in transit. A kiosk also could serve as a "filling station" for a portable device.

- Network – Content can be delivered electronically over any number of different networks and to any number of different platforms. The Internet and cellular telephone networks are the key networks for distribution of music, but any digital network can carry musical content. We are excited about the possibility of making music available to the public over WiFi networks (i.e., wireless data networks such as those available at airports, hotels and coffee shops). There also are opportunities for so-called "viral" distribution over peer-to-peer networks or through "send to a friend" functions, where locked content is disseminated from person to person, but only can be accessed (except for limited previewing) after a purchase transaction.
- Platform – Different types of devices (platforms) can be used to access music over different types of networks. Computers, cell phones, other wireless devices, and dockable portable devices such as iPods are important platforms today, but other platforms such as video game consoles, television set-top boxes, and televisions equipped to receive Internet Protocol television ("IPTV") (i.e., television signals transmitted by means of broadband Internet connection) may be important in the future.
- Usage Rules – Computer software called a "digital rights management" or "DRM" system gives content distributors the ability to determine how the content will be used. Encryption technology is used in DRM systems to prevent unauthorized uses. By using a DRM system, consumer copying can be prohibited, or permitted to only a limited degree; moving content to a portable device such as an iPod can be permitted

or not; access can be given for a limited period of time, or a limited number of plays; access can be denied (or permitted for only limited previewing) until the consumer purchases the content (so-called "locked content"); and other opportunities to upsell consumers to higher-price levels of access can be provided. SONY BMG requires all of its commercial digital distribution partners to use DRM systems to protect our music, and negotiates with them over appropriate usage rules.

- Functionality – Recorded music products didn't used to have functionality; they simply were played. Today's technology permits distribution of content coupled with computer software to enable users to do things with the content other than just play it. For example, a product in the U-MYX format is an audio recording coupled with rudimentary audio editing software to engage the consumer in enjoying the recording in ways other than as a passive listening experience.
- Bundling – Most of the music we sell can be obtained for free from pirates. The challenge of our business is to get people to pay for items that they can obtain for free. An analogy to bottled water is apt. Water is basically free (albeit not from pirates), but people pay for it in bottles. We likewise need to find innovate ways to package music that consumers will want to pay for. Today's physical formats do not need to contain only audio recordings. Modern physical formats allow us, on a single disc, to combine different types of content and formats, make products playable on multiple platforms, apply different usage rules (or none) to some or all of the content, and even integrate online content. For example, our DVD-Audio releases typically have audio tracks in both stereo and surround sound, as well as some combination of photo galleries, artist biographies, and video content. We also have created multi-disc

packages, such as a DVD motion picture bundled with the CD soundtrack album. In the case of electronic delivery, individual track downloads have dominated, but we would like to encourage consumers to buy more music. One way to do that is by offering innovative bundles of content – for example, an audio track, a remix and artist interview together in a bundle that feels like a good value to the consumer.

- Business model – It used to be that products were sold at wholesale and resold at retail, without nearly so much discounting as occurs at both levels today. Now technology has enabled wholesalers and retailers to structure the relationships between them, as well as the retailer's relationship with the consumer, in any number of different ways. At retail, the goal is to appeal to consumers with different styles for interacting with music and at different price points. Thus, the permanent ownership (sale) model is still dominant, but we are very interested in subscription offerings that provide users with access to music on a "time-out" or "rental" basis. In addition, "hybrid" models that combine elements of both permanent ownership of selected repertoire and a monthly subscription offering are also evolving within this rapidly changing marketplace. Moreover, we are seeing advertiser-supported offerings that seem like they might generate an appropriate level of income. We are also looking at prepaid music cards to encourage consumers to make impulse online purchases. We now have the ability to appeal to a wide range of consumers with different levels of access to music at different prices.

These eight parameters create a rich palette from which record companies and their technology partners can create innovative new kinds of products and services, with almost infinite variation, by mixing and matching from among the range of options I have described for each. We work within SONY BMG and talk with music service providers and technology companies all the time to figure out how to mix and match these options to create compelling new offerings. We have only begun to scratch the surface of what we might see over the next five years. To make this more tangible, here are some examples of important kinds of offerings currently in the marketplace:

- Online Download Services – Permanently-accessible downloads sold over the Internet were the first and remain the dominant electronic offering. Today, we have deals with in excess of [redacted] different online services for the online distribution of permanent downloads of our recordings. Some of the best-known of these services are Apple's iTunes, Yahoo! Music, and AOL MusicNow. While download sales have dominated, there are potentially other pricing models that could also generate an appropriate level of revenue. For example, a new service called SpiralFrog is proposing to offer advertiser-supported downloads.
- Online Subscription Services – SONY BMG has commercial distribution arrangements with in excess of [redacted] services that provide Internet-based "on-demand" streams and limited downloads (i.e., downloads made using DRM systems to enable access to the downloads only for the duration of the subscription). These services include Yahoo! Music, RealNetworks' Rhapsody service, and AOL MusicNow. Services typically also use DRM systems to charge a higher price for "portability" (i.e., the ability to transfer content to a portable device). The service's offering to the consumer may include other types of music use as well, including videos, pre-programmed webcasting, personalized webcasting and permanent downloads.

Sometimes the same service provider also offers some of the same kinds of offerings on a different price basis (such as advertiser-supported webcasting).

- Video – SONY BMG has entered into agreements with over [redacted] different services for streaming of videos selected by viewers (so-called "on-demand" or "pulled" streams), preprogrammed streams (so-called "pushed" streams, which offer a user experience more like television), personalized streams or video downloads (i.e., downloads of videos, in much the same manner as audio downloads). These include services that deliver videos over the Internet to computers, as well as services that deliver videos over wireless networks to cellular phones and similar devices.
- Telecommunications Products – We have deals with the four major national cell phone carriers, over [redacted] other ringtone aggregators, mobile virtual network operators (known as "MVNOs"), and other service providers for delivery of the full range of musical products over cellular telephone networks to telephones and similar devices. Some available offerings include:
    - Downloads of mastertones (also called "master ringtones," "ringtunes" and "true tones"), which are typically short (usually 15-30 seconds in length) excerpts of commercially-released sound recordings distributed for use to announce an incoming call or message.
    - Downloads of monophonic and polyphonic ringtones – short excerpts of musical works that have been recorded in synthesized versions and are downloaded for use in a cellular phone or similar device to announce an incoming call or message. The most basic in musical terms are monophonic ringtones (which contain only a

musical work's melody). Somewhat more complex musically are polyphonic ringtones (which contain a work's melody and harmony).

- Full-song downloads.
- Ringback tones, which are recordings played to incoming callers instead of a conventional "ring" while waiting for the purchaser of the ringback to answer a call.
- Videos – both streaming and downloads of music videos.
- Video ringtones – excerpts of music videos distributed for use in a cellular phone or similar device to announce an incoming call or message.
- Landlines - ringtones and ringbacks may present a market opportunity for land line telephones as well as the cellular phones for which they have been available to date.

Most of these different kinds of services are typically offered through a conventional sale model, although the subscription model has been evolving in this area as well.

The pricing of products in the market, both at the retail and wholesale level, varies with the nature of the offering. Even within a particular format, there can be differential pricing, such as based on the age of the recording. For example, we have long offered CDs at different price points, which we refer to as "front-line," "mid-price" and "budget" (with current wholesale prices generally $[redacted], $[redacted] and $[redacted], respectively). By varying the price points of our products in this way, we can prolong the commercial life of recordings that are no longer selling at higher price points. Sometimes the price variation may not be intuitive. For example, consumers are generally willing to pay $2.50, or even as high as $2.99, for mastertones, which is much greater than the prevailing price for full-song downloads (a single track being 99 cents on iTunes). Online sales prices are easy to change quickly, or even automatically, in response to market conditions (just like the price of airline tickets). In the future, greater price variation - product-by-product, day-by-day and region-by-region - will be increasingly important to our eking out every bit of incremental profit we can from a product.

Most of the different product and service offerings encompassed within the range of parameters I described will implicate musical work reproduction and distribution rights and be licensable under the Section 115 compulsory license, but others will not. However, as I described, a single consumer offering may include aspects subject to Section 115 and aspects that are not subject to Section 115. The rates and terms determined in this proceeding should be sufficiently flexible to allow us to draw upon the rich palette of options available to design new products and services.

B. Contributions of Record Companies and Their Technology Partners

The new product and service offerings I have just described do not just spring into being. New distribution channels and technologies require high capital investments, clearing consumer acceptance and licensing hurdles, and new categories of recurring cost. For every new product or service type, there is a considerable creative effort and investment to design the product type, promote it to consumers, teach labels how to produce products of that type, implement the necessary technology and infrastructure, and address rights clearance issues. Once a format is launched, products of that type have to be produced, and while we produce sound recordings to distribute them, there is an incremental production cost associated with every related product we produce. These include the costs of repertoire specialists, sales and marketing personnel, production engineers, digital operations staff and rights clearance staff. Not all products will sell enough to recover even that incremental cost. We bear the risk of failure, of a new format as well as of any individual release in that format. Writers and publishers do not make these kinds of creative, production, and technical contributions or incur these kinds of costs or risks.

SONY BMG has been a leader in developing the marketplace for digital distribution. At Sony, we created an Electronic Music Delivery ("EMD") department and started selling downloads from our website in 1998, five years before Apple launched its iTunes Music Store. Sony and BMG have been involved with online subscription music services from the beginning. In 2000, Sony joined with Universal Music Group to form Duet (later pressplay, and the predecessor of the new, legitimate Napster subscription service). At about the same time, our future BMG colleagues joined with EMI, Warner Music Group and RealNetworks in MusicNet, which nowadays provides content and "white label" technology to power a number of subscription music services. Today, we have deals with at least [redacted] subscription services and [redacted] permanent download distributors for various categories of products and services delivered electronically and we are working to develop more.

We have invested considerable time, resources, and money across every aspect of our operations to make this possible. We have reengineered our computer systems and business processes and, during a period when our workforce has shrunk by about [redacted]%, we have hired creative staff to produce content in new formats; technologists to create and implement new kinds offerings and the infrastructure necessary to make them happen; sales people to manage relationships with digital retailers; lawyers and business people to negotiate the complex license agreements we enter into with our partners (in contrast to the purchase orders on which our physical product business has been conducted); and copyright clearance professionals to clear rights to the necessary musical works. Over the past five years we have invested in excess of $[redacted] million in transitioning to the digital age. This includes the obvious costs such as digitizing our sound and video files to meet the specifications of our various partners, an infrastructure to label, store, deliver and manage those files, as well the costs of transforming our operations to negotiate myriad new business arrangements and comply with the resulting clearance, licensing and accounting requirements. These are not all one-time conversion costs, but will continue through the rate period as new products and services are introduced. This past year, we spent $[redacted] million company-wide to manage our existing digital collection and continue digitizing new music. We also spent $[redacted] million in the last year alone developing new formats. We have also spent $[redacted] million on an antipiracy effort known as "spoofing," to fight piracy on peer-to-peer networks.

We also serve an important role in the emerging digital marketplace by aggregating musical work and sound recording rights. There are tens of thousands of music publishers in the U.S. SONY BMG regularly makes royalty payments to some 12,000 of them. That means that without us, a service that wanted to make our whole catalog available to the public, and license sound recordings from us and musical works from publishers, would need to get licenses from about 12,000 publishers. Not surprisingly, almost all of our distribution partners insist that we bear the burden of handling their mechanical licensing. In a highly diffuse music publishing market, our ability to clear musical work rights, aggregate them, and handle the administration of those rights acts is essential to the launch of new services. That ability comes at a high price to us, as I understand my colleague Andrea Finkelstein will testify.

SONY BMG has also been a leader in physical product innovation. We have participated in developing standards for, and been quick to embrace, new physical formats like DualDisc and SACD. In fact, I anticipate that the pace of our experimentation and investment in physical formats will increase in the coming years, as we seek to capture as much revenue as possible from physical formats.

C. <u>Marketing and Promotional Innovation and Investment</u>

As the music marketplace continues its rapid transformation, we need to find innovative ways to promote music to ensure continuing sales in the face of the harsh business conditions I outlined above. In an environment where so many trends are creating downward pressure on sales, and consolidation is making radio a less useful and available promotional tool for us, we need to work harder than ever – and make a larger promotional investment than ever – to generate more revenues to benefit everyone in the music value chain. We still need to market and promote our products in all the ways we used to, including television advertisements, product placements, store displays and supporting tours of our artists. In addition, we now we make additional efforts and investments in online promotion. We work closely with our online distribution partners to design online promotions that we believe will maximize our revenues from a release. I will describe a few examples:

- <u>Artist Websites</u> – These days every artist needs a website to help connect the artist to his or her fan base through a variety of features – including news, photos, tour information, the opportunity to sign up for a fan club or email distribution list, opportunities to buy music and sometimes other merchandise, and the opportunity to hear some of the artist's music. SONY BMG typically develops and operates its artists' websites, because they are an important part of creating the artist's brand and selling the artist's music. We spend approximately [redacted] on the design and development of artist websites. We spend approximately [redacted] for computer infrastructure, hosting, and bandwidth for artist and related websites.

- Exclusive Content – Large retail accounts want to be able to offer their customers something they cannot get anywhere else. We see this with big box retailers like Wal-Mart, Target and Best Buy. We frequently are asked to create specialized albums for these retailers that have extra bonus tracks, and the Eagles are preparing to release an album exclusively through Wal-Mart. Major telephone carriers frequently demand exclusive mastertones and full track downloads in exchange for providing much-needed visibility on the screen of a cell phone (so-called "deck space"), which is equivalent to an endcap or other promotional display in a traditional record store.
- Online Appearances – Having the artist make live appearances on digital music services has become an important part of many promotional plans.
- Online Advertising – The websites of legitimate digital music distributors like AOL, Yahoo Music, iTunes and Amazon.com receive a large number of visitors who are inclined to pay for music. We invest in advertising on these sites, and are always looking for ways to make more effective use of this new advertising medium. (I note, however, that these advertising opportunities are distinct from the ordinary use of content by these distributors. For example, "webcasting," which is the transmission of preprogrammed channels of recordings, is not a promotional activity and should not be confused with our advertising and other coordinated promotional programs through these same services.)
- Online Special Offers – A particularly powerful way to sell music online is through special offers that make the consumer feel like he is getting extra value. These can include special bundles or special pricing. One good form of targeted marketing is "prebuys" on sites like Amazon.com, which allow consumers to purchase a physical

product before its official release date. We have partnered with Amazon to allow it to offer consumers who prebuy a CD the ability to stream or even download the music during the two weeks before the official release date, helping develop "buzz" for the album during the buildup to release. While we believe this is a good way to boost sales, and thereby generate mechanical income for publishers, our ability to offer these kinds of promotions has been limited by publishers' demands for payment for both the CD and the transmissions.

- Purchase Opportunities – We are always looking for ways to create opportunities for consumers to purchase music, or to upsell them to purchases that will generate more revenue. These include working with services to include "buy buttons" on their websites.
- Previewing – Consumers want to hear what they are buying before they buy it. That is why there have long been listening posts in record stores. Consumers expect to preview tracks before they buy them online. Accordingly, we invest in preparing promotional excerpts of each track and make them available to our distribution partners to stream for previewing.
- Free Downloads and Streams – We are not in the business of giving away our product, but it makes sense to give away a little to try to get a lot more in sales. For example, having a track from an album as the featured free download of the week at the iTunes Music Store can be a great way to gain significant exposure for an unknown, developing artist and, ultimately, to boost sales. We also work with our distribution partners to define free trial periods for subscription offerings.

IV. Problems with Musical Work Clearance, and Our Solution

As we have moved to distribute as much of our catalog as possible through new media, we have time and again run into problems clearing rights to musical works. Indeed, music publishers have resisted all our recent major efforts to launch new products and services in which we were making huge investments to drive sales of products from which they would benefit. These problems go as far back as 1999-2000, when publishers refused to issue licenses for downloads and subscription services until industry agreements were negotiated between RIAA and NMPA.

In 2003-2004, a series of these problems came to a head. We were very excited about the DualDisc format (i.e., a disc with a CD on one side and a DVD on the other), because it offered the opportunity to transition consumers from the dying CD format to DVD – a format that is growing in popularity and much less prone to piracy. We were heavily involved in developing the DualDisc format, and thought that it offered a lot of promise in prolonging physical album sales. Moving ahead with DualDisc was a major corporate initiative. We invested millions of dollars in developing and consumer-testing the format, establishing manufacturing capabilities, marketing the format, developing policies for releases in the format, and everything else we need to do to launch a new format.

Since our goals of selling albums and transitioning consumers to more secure formats help publishers, we believed the publishers would share our enthusiasm for the new DualDisc format. Instead, evidently sensing the opportunity to extract a financial windfall from us, publishers asserted that we were required to pay two mechanical royalties for each audio track – one for the CD side and one for the duplicate version of the song appearing on the DVD side (in addition to synchronization royalties for any video material on the DVD side). In 2004, The

Harry Fox Agency sent a notice to all of its licensees so stating. Its notice is attached as RIAA Exhibit F-101-DP.

The publishers' position was untenable from our perspective, as both a business and legal matter. We targeted DualDiscs for sale at approximately the price of a CD, or only a little more, yet our production and manufacturing costs were higher than for a CD, and we expected to have to pay synchronization royalties for the video content. There were no margins to give the publishers anything more. As a matter of law, the statutory rate is payable for "every phonorecord made and distributed."[1] One DualDisc cannot be two phonorecords. However, overcoming the publishers' intransigence by relying on the compulsory license was not realistic as a practical matter. We needed a way to clear mechanical rights efficiently.

We also faced a problem of how to clear efficiently the video content for DualDiscs. Video is not covered by the compulsory license, so we could not rely on it for that. Sometimes we could rely on our controlled composition clauses. As I understand Cary Sherman will testify, these are provisions in contracts between artists or producers and record companies in which an artist or producer who is also a songwriter grants a mechanical license, and typically also certain video synchronization rights, with respect to the artist's songs. When we could not rely on a controlled composition clause, we were faced with the prospect of laboriously negotiating one-off synchronization licenses on content that we hoped might sell more albums, but wouldn't get us a materially higher price. We had to minimize the transaction costs such negotiations would entail.

If our strategy of launching DualDisc was not to come grinding to a halt, we needed to do something out of the ordinary. We decided to engage EMI Music Publishing, the largest music

[1] 37 C.F.R. § 255.3(m) (attached as RIAA Exhibit F-102-DP).

publisher, in a negotiation to create a framework for licensing mechanical and synchronization rights for DualDisc. Although our goal was simply to confirm the unremarkable proposition that one statutory mechanical royalty is payable for each track on a DualDisc – just like a CD – and agree to reasonable synchronization royalties for DualDisc, the reaction we received was "What's in it for me?"

EMI Music Publishing was poised to use this opportunity to license mastertones at rates well in excess of the statutory rate. We firmly believed both DualDiscs and mastertones are covered by Section 115. Publishers vigorously contested the latter proposition, but as the Copyright Office recently ruled, their position was erroneous.[2] The price of being able to license one format covered by the compulsory license (DualDisc) at the statutory rate should not be having to license another format covered by the compulsory license (mastertone) at a multiple of the statutory rate.

However, the compulsory license is so burdensome to rely on that it was not a practical option for us. We were also struggling with licensing for other types of products and services as well, some covered by the compulsory license and some not:

- <u>Videos</u> – A market for paid use of music videos was just also beginning to emerge. One of our other most important corporate initiatives was beginning to generate revenue from our library of thousands of videos. We could not afford the delay or transaction costs of negotiating individual synchronization licenses for each one. Yet there is no compulsory license for videos, and publishers seemed to be in no hurry to

[2] *See In the Matter of Mechanical and Digital Phonorecord Delivery Rate Adjustment Proceeding*, Docket No. RF 2006-1 (Oct. 16, 2006) (attached as RIAA Exhibit F-103-DP).

tap into the video market, even though this would result in increased revenues for publishers.

- Copy-Protected CDs – We faced exactly the same problems with copy-protected CDs as with DualDiscs. For years we had been evaluating 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. By 2003-2004 we thought we 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 (even though preventing piracy is in their interest, as well as ours). (Because of controversy concerning the technology we employed, we are not currently distributing copy protected CDs commercially until such time as we can find a less controversial security technology. However, we were very interested in the format at the time.)
- Ringback Tones – The legal status of ringback tones was unclear, and we were anxious to partner with carriers for both mastertones and ringbacks.
- Preloaded Locked Content – We were interested in being able to offer DRM-protected recordings preloaded on a computer hard drive or cell phone memory card, where usage rules permit the music to be played only for limited previewing, unless the consumer buys permanent access. However, it was not clear that payment would be due only when a track was unlocked and we were paid.

We eventually decided that if we had to pay more than the statutory rate for mastertones to overcome the deficiencies in the compulsory license we could do that, if we could clear up all of the problems that were holding up our entry into all these new markets. In November 2004, we entered into a New Digital Media Agreement ("NDMA") with EMI Publishing doing just that. Immediately thereafter, we sought to do similar deals with other publishers, and have similar arrangements with all of the major publishers and several significant independent publishers.

There are a number of factors that were central in our decision to enter into our NDMAs. Those factors must be taken into account when looking at their terms, and all of them counsel that the NDMAs are not an appropriate precedent for the determination of rates and terms in this proceeding:

- The NDMAs Were a Package Deal – We would not have agreed to the mastertone/ringback rates in isolation. NDMAs covered a package of rights in numerous different products. We negotiated the best deal we could considering our priorities of DualDisc and video. We agreed to the mastertone/ringback rates in the give and take of negotiating the whole package, so we could get to market quickly with DualDiscs and videos.
- On a Short-Term Basis at the Time the Mastertone Rates Were Acceptable – Our NDMAs are for terms of only about two years. We viewed them as an experiment. In 2004, mastertones were a new marketplace. The publishers were holding up our entry into that marketplace, and we thought it was important to get into the market quickly, because the market might prove to be short-lived (*e.g.*, because consumers would make their own mastertones). We did not have time to fight over compulsory license coverage. We also viewed mastertones as ancillary income, although now that the market is established we factor it into our financial analysis of new releases, so it is no

longer ancillary. As the mastertone market matures, mastertone rates should fall more in line with historical norms.

- We Had to Resolve DualDisc and Video Licensing Problems – Getting to market with DualDiscs and videos, where in each case we needed synchronization licenses outside the scope of Section 115, were critically important corporate initiatives. Resolving our issues with respect to these formats in a timely manner was our main motivation in entering into the NDMAs.
- We Resolved DualDisc and Video Licensing Problems on Favorable Terms – In the case of DualDisc, we agreed to pay mechanical royalties on the same basis as for CDs. Since this issue started with publishers asking for twice that, this was a big "get" for us. We also got reasonable synchronization royalty rates for DualDisc, and a cap often applies to our royalty obligation (so we may pay even less than the stated synchronization royalty rate). In the case of videos, we achieved our goal of getting to market immediately. We were not able to agree to rates, but we agreed to a dispute resolution process that ensured that we could not be held hostage on rates. Thus, our agreement with respect to DualDisc and videos fully satisfied our going-in objectives.
- The Mastertone Rates Are the Price We Paid – To get the deal we wanted on DualDisc and videos, we agreed to pay mastertone rates that are too high. We pay the greater of [redacted]% of retail, [redacted]% of wholesale or a "floor" of [redacted] cents (although the floor is low enough that our payment is always well above it). Because of the retail rate, we sometimes end up paying over [redacted]% of the wholesale price. At these rates, our share of the retail price of a mastertone is much lower than in the case of digital download sales.

- Past Practice Constrained Lower Mastertone Rates – Publishers had been entering into deals with mobile companies for years for monophonic and polyphonic ringtones. I was told that these deals tend to include rates at or above those we agreed to - attributable to the fact that only the musical work copyright was involved. Without the need to pay for rights to sound recordings, the mobile distributors were satisfied paying these ringtone rates. Upon the introduction into the marketplace of mastertones in 2004, sound recording rights became relevant to the economics of ringtones. However, music publishers and mobile distributors worked together to create "sound alike" mastertones that were even marketed under the names of recording artists, without paying artists or record companies. At the same time, the mobile distributors established a "ceiling" for the "all-in" content rate at 50% of their receipts, admonishing the record companies and publishers to allocate the proceeds amongst themselves, as the distributors simply were not going to pay any more than that in the aggregate. When that transpired, the publishers emphatically resisted accepting anything less in royalties for mastertones than they had been receiving for monophonic and polyphonic ringtones. Record companies were forced to accept this "line in the sand" position or sit out of the market.
- We Could Not Rely on the Compulsory License – It was impracticable to rely on the compulsory license for mastertones. Even if we could have gotten licenses for all the repertoire we wanted when we wanted it, on low sales volumes our additional costs of administration might have eaten up much of the rate difference. Essentially, we agreed to the rates we did in exchange for administrative convenience. It would be

particularly perverse to use premium rates agreed to so that we could avoid using the compulsory license as a benchmark to set rates under the compulsory license.

For all the reasons I have just described, the royalty rates contained in the NDMAs, viewed in isolation without considering the entire bundle of rights successfully negotiated in these agreements, would be inappropriate benchmarks to use in setting the statutory mechanical royalty rate.

V. <u>The Appropriate Royalty Rate Structure and Rate for the Digital Age</u>

Over the last decade, there has been a sea change in the music marketplace. The rates set in this proceeding need to reflect that change. I have reviewed RIAA's rate request in this proceeding, and I support it. There are two key aspects to that proposal: a percentage royalty rate, and rates that are lower than today's rates. Both of those aspects are necessary to adapt to the new environment, maximize the availability of music, recognize and promote investment and innovation that will grow the music business in a way that benefits all parties, and provide all industry participants with a fair return or fair income under existing economic conditions. I will address each in turn.

A. <u>Percentage Royalty Rate</u>

To equip the music industry for the emerging marketplace, we need a percentage rate royalty structure.

When record companies sold basically one product, a "cents rate" royalty structure worked fine, so long as rates roughly tracked the price of that product to avoid undue pressure on margins. However, as I have described, we no longer sell one product. Most notably, we have partnered with a large number of service providers to make our recordings and associated musical works available to the public in all kinds of forms and at all kinds of price points. From my discussion of the eight dimensions of innovation, it should be clear that we have only scratched the surface in terms of the multiplication of different types of service offerings. On the physical product side, in addition to traditional physical products, we sell new physical products such as DVD-Audio discs with content other than audio recordings. Here too, there is plenty of room for innovation as we try to prolong the life of physical formats.

It is hard to imagine how the Judges would even go about setting a cents rate royalty. It would make no sense to adopt a single cents rate for every activity within the scope of Section 115. The differences in pricing and business models between the physical products, downloads, and subscription services that are covered by Section 115 are simply too great for there to be any rational one-size-fits-all number. So one would need to define a vast array of different rate categories and have a distinct cents rate for each. Physical products, downloads and subscription services would just be the start of a set of rate categories. However, to reflect pricing differences fairly, there really should be separate categories that distinguish wireless from mobile distribution, different usage rules, different types of bundles, and different price points (e.g., for new front-line releases and lower priced catalog recordings). It would not be hard to imagine a dozen or more rate categories, with the potential for dispute about how new products should be classified. Moreover, if new kinds of products and services are devised during the next five years and priced differently than the existing products and services in the rate category, or if prices of existing products and services rise or fall, the cents rate would not reflect the relative roles of copyright owner and user to the same degree, or afford the copyright owner a comparable return and the copyright user a comparable income. In today's diverse product environment, I simply do not see how the Judges could satisfy their statutory mandate to set royalty rates that achieve the objectives set forth in Section 801(b)(1) of the Copyright Act[3] with a cents rate.

By contrast, the advantages of a percentage rate are clear:

- Balance Between Copyright Owners and Users is Automatic. No matter what new kinds of products and services are devised during the next five years, how they are priced, and how prices of existing products and services rise or fall, assuming the rate was set at the right level, it always would reflect the relative roles of copyright owner and user to the same degree, and afford the copyright owner a return, and the copyright user an income, that are in balance.
- Flexibility to Create New Types of Offerings – A mechanical royalty based on a percentage of actual wholesale revenues would promote innovation by making new types of product and service offerings possible. The problem with a "cents rate" royalty is that it assumes a certain set of economics. Products that don't conform to those economics become impossible. In today's challenging business environment, nobody can afford to write off whole classes of products as impossible. We are driven to assess the market and the possibilities created by new technology, figure out what music buyers want, how much they want, and how much they are willing to pay. A percentage rate encourages the industry to experiment with new products and services. If some product or service at some price point can find a market among people who would not otherwise pay for music, that product or service should be available to the public and generate income for everyone in the music value chain. It should not be

[3] 17 U.S.C. § 801(b)(1) (attached as RIAA Exhibit F-104-DP).

precluded by a rate that is too high because it was based on the economics of different offerings.

- Flexibility to Change Prices – The Internet provides enormous pricing flexibility. In the past, changing retail prices meant changing the price tag on each unit of product. Today, prices advertised on the Internet can be changed instantly with a few keystrokes. Online retailers now have the capability to adjust prices instantly if that will stimulate demand and lead to an overall increase in revenues. By moving to a percentage rate, if lowering the price leads to more sales and more total revenue, then both the record companies and the publishers win, because the overall pot of revenues is larger. However, if we need to pay a fixed cents rate per track, we need to structure our deals with retailers in a way that ensures that we can pay that cost and still have a sufficient margin to allow us to cover our costs and achieve some return on our investment. That, in turn hampers our ability to structure special offers and the retailer's pricing flexibility to our collective disadvantage.
- Avoiding Delays in the Launch of New Offerings – In the past, as we have struggled to bring new products and services to market under the current inflexible cents rate structure, our only option for overcoming the inflexibility of the cents rate was protracted negotiations at either the industry or individual company level. In the case of subscription services, we concluded an industry agreement for their licensing in October 2001, but mechanical licensing difficulties delayed the launch of subscription services by perhaps as much as a year. In the case of DualDisc, we have concluded our NDMAs, but the launch of DualDisc was delayed by perhaps as much as a year.

What good is a compulsory license that only works after protracted negotiations and considerable transaction costs?

- Share Risks/Rewards – The recording business is a risky business, and the current business environment has made those risks much greater. It is hard to find money to invest in major initiatives like the launch of a new format. It is also hard to justify investing a lot of money in the launch of a new format in view of the risk that it will not succeed, or not succeed at the price one might hope. A percentage royalty would more equitably share the risks and rewards of new ventures. It would protect innovators like record companies and their technology partners from some of the downside risk, while at the same time giving writers and publishers an upside reward if the investment pays off.
- Enable Artistic Freedom and Maximize the Availability of Works – Artists like to record more tracks on their albums, and including more tracks makes a greater number of creative recordings and musical works available to the public, creating income opportunities for more writers and publishers. However, we can only afford a certain amount of mechanicals cost. Currently, we can allow artists substantial freedom to choose how many tracks to include on their albums when we have a controlled composition clause that caps our mechanicals cost, and so functions much like a percentage royalty. Otherwise, we would need to make tougher economic decisions about how many tracks we can afford to include on an album. However, discounted rates under controlled composition clauses do not apply to electronic delivery, because the statute supersedes such rates for electronic delivery of recordings made under

contracts entered into after June 22, 1995.[4] That usually was not economically significant when electronic delivery represented a small part of the market. However, as electronic delivery becomes more and more important, we will need to limit the number of tracks in online album sales to manage our mechanicals cost unless the rate structure permits us to continue to leave this discretion to the artist.

- Prolonging the Life of Physical Formats – The CD format is in terminal decline, and in the long term it is not clear that any physical format can be sold successfully without some form of value-added content. Yet squeezing every last dollar possible out of physical formats is very much in everyone's interest. We all do better selling relatively high-price albums rather than relatively low-price individual track downloads. We have tried to stave off the death of physical products through the new formats I have described, as well as by offering CDs with more tracks. However, this is only possible when we can rely on a controlled composition clause to cap our mechanicals cost. Moving to a percentage royalty would go even further and allow us to give the consumer a little more value in physical products, and hopefully sell more of them for longer.

If the Judges adopt a percentage royalty structure, it should be a percentage of the actual wholesale price paid. That is a real number that we know and control. In today's environment, 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. Actual retail prices are generally reported to us by music service providers, but we do not control them. If retail prices rise or fall without a corresponding change in our wholesale price, it would make no sense for our

[4] 17 U.S.C. §115(c)(3)(E) (attached as RIAA Exhibit F-105-DP).

mechanicals cost to rise or fall, because we at SONY BMG are paid at wholesale, not retail, prices.

B. Lower Royalty Rate

Today's royalty rates are too high, because they have for years risen faster than record prices, and then when record prices started falling in 1999, they kept going up. The effect has only been exacerbated by downloads at lower per-track prices than albums. The mechanical royalty rate is not only at an all-time high on a cents basis, but way out of line with historical and international norms when considered on a percentage of wholesale basis. It is out of proportion to the huge creative and technological contributions, investments, costs and risks of record companies, and it is unfairly intensifying the pressure on our margins. I understand that the testimony of David Teece will explain clearly the misalignment between the record companies' contributions and the mechanical rate.

The royalty rate this panel selects should reflect the contributions that SONY BMG and other record companies have made and continue to make to maximize revenues from music, particularly in this difficult time of transition. Moreover, for the music business to survive and thrive, we need to be able to continue making these investments in new products and services. A royalty in the range of RIAA's proposal would more accurately reflect the role record companies play in technological and business innovation, and will allow us to continue making investments in innovation.

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

R Wilcox
Ron Wilcox

Date: NOV 29 2006

Exhibits Sponsored by Ron Wilcox (Public)

Exhibit Number	Description
F-101-DP	Important Notice Concerning Licensing of Multisession Products, dated December 3, 2003
F-102-DP	37 C.F.R. § 255.3
F-103-DP	*In the Matter of Mechanical and Digital Phonorecord Delivery Rate Adjustment Proceeding*, Docket No. RF 2006-1 (Oct. 16, 2006)
F-104-DP	17 U.S.C. § 801
F-105-DP	17 U.S.C. §115