PUBLIC VERSION

Before the
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LIBRARY OF CONGRESS
Washington, D.C.

In the Matter of	)	
DIGITAL PERFORMANCE RIGHT IN SOUND RECORDINGS AND EPHEMERAL RECORDINGS FOR A NEW SUBSCRIPTION SERVICE	)	**Docket No. 2005-5 CRB DTNSRA**

WRITTEN DIRECT STATEMENT OF SOUNDEXCHANGE, INC.

Volume 3 of 6
Designated Testimony from 2005-1 CRB DTRA:
Written and Oral Testimony of Michael Pelcovits

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SX Trial Ex. 4

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Public Version

<u>Written Direct Statement of SoundExchange, Inc.</u>
Volume 3 of 6: Designated Testimony from 2005-1 CRB DTRA: Written and Oral Testimony of Michael Pelcovits

Written Testimony

Oral Testimony

- May 15, 2006 (Open)
- May 15, 2006 (Closed)
- May 16, 2006 (Open)
- May 16, 2006 (Closed)

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DIGITAL PERFORMANCE RIGHT IN SOUND RECORDINGS AND EPHEMERAL RECORDINGS	)	Docket No. 2005-1 CRB DTRA

TESTIMONY OF

MICHAEL PELCOVITS

Principal, Microeconomic Consulting & Research Associates (MiCRA)

PUBLIC VERSION

October 2005

Before the

UNITED STATES COPYRIGHT OFFICE

Library of Congress
Washington D.C.

Testimony of MICHAEL D. PELCOVITS

I. INTRODUCTION AND QUALIFICATIONS

My name is Michael Pelcovits. I am a Principal of the consulting firm Microeconomic Consulting & Research Associates, Inc. ("MiCRA"), which specializes in the analysis of antitrust and regulatory economics. My business address is 1155 Connecticut Avenue, Washington, D.C. 20036.[1]

Since joining MiCRA in 2002, I have prepared reports and testimony on a wide range of telecommunications and applied microeconomic issues. I have consulted for major corporations in telecommunications and other industries and provided testimony before the Federal Communications Commission, many state regulatory commissions, the Office of Telecommunications (Oftel) in the United Kingdom, the European Commission, and the Ministry of Telecommunications of Japan.

Prior to joining MiCRA, I was Vice President and Chief Economist at WorldCom. In this position, and in a similar position at MCI prior to its merger with WorldCom, I was responsible for directing economic analysis of regulatory and antitrust matters before federal, state, foreign, and international government agencies, legislative bodies, and courts. Prior to my employment at MCI, I was a founding principal of a consulting firm,

[1] A copy of my curriculum vitae is attached as Appendix B.

Cornell, Pelcovits & Brenner. From 1979 to 1981, I was Senior Staff Economist in the Office of Plans and Policy, Federal Communications Commission.

I have conducted analysis and research on economic issues related to the Internet for the last several years. During my tenure at MCI, I worked closely with the Internet engineering group to help formulate public policy positions relating to the Company's wide ranging business activities in the Internet.

I have lectured widely at universities and published several articles on telecommunications regulation and international economics. I hold a B.A. from the University of Rochester (*summa cum laude)* and a Ph.D. in Economics from the Massachusetts Institute of Technology, where I was a National Science Foundation fellow.

II. OVERVIEW OF TESTIMONY

I have been asked by counsel for SoundExchange to analyze the market for Internet music services and provide a recommended rate for the compulsory license fee to be set in this proceeding for the digital audio transmission of sound recordings under the statutory licenses set forth in 17 U.S.C. § 114(f)(2)(B) and 17 U.S.C § 112(a)(1). My goal has been to develop a rate that fully comports with the statutory requirement, discussed more fully in Section III of my testimony, that license rates should "most clearly represent the rates and terms that would have been negotiated in the marketplace between a willing buyer and willing seller."[2]

In summary, I have concluded that a market rate can best be derived by analyzing the license fees that have been negotiated in the recent past between willing buyers and

[2] 17 U.S.C. § 114(f)(2)(B).

willing sellers in a very similar market. The economic rationale for this "benchmark" approach is explained in Section IV of my testimony. In that section, I also explain that the market I have selected as the most appropriate benchmark from which a statutory license fee can be derived in this proceeding is the market for non-portable interactive digital music services (for example, interactive music services such as Rhapsody or Napster Membership). The sellers of copyrighted material in the market for interactive digital music services are the same entities who are "sellers" in this proceeding, and many of the buyers in that market are also "buyers" in this proceeding. The license fees negotiated in the interactive digital music services market transferred the right to use the same digital audio transmissions that are the subject of this proceeding. Because of these similarities, among others, I have used the contracts (described in Section V of my testimony) negotiated by the four major record companies in the interactive digital music services market as the benchmark from which to derive an appropriate statutory license rate for the services at issue here.

There are, of course, some differences between the benchmark market and the market at issue here, most notably that the music service providers who were buyers in the benchmark market provide interactive services to their customers, while the "buyers" in this proceeding provide non-interactive services. In Section VI of my testimony, I describe adjustments to the proposed statutory license fee that account for these differences. These adjustments reflect differences in the value of an interactive and a non-interactive license, as well as differences in the way the services are used and the impact that each type of service may have on other revenue streams for the willing buyer and willing seller.

Section VII presents evidence on copyright fees in some other markets, which serve to verify the methodology and recommendations that I have made. Finally, in Section VIII, I discuss the rapidly evolving market for streaming services provided on mobile devices. Music services may utilize the statutory license to make transmissions to mobile devices, and in the free market copyright owners would command a premium for a distribution of their works in any fashion that makes them portable or accessible via a wireless device. I propose that the Board establish royalty rates that recognize this market premium placed on mobile services.

III. FRAMEWORK FOR ANALYZING THE WILLING BUYER/WILLING SELLER STANDARD

A. Willing Buyer/Willing Seller Standard

In its prior decision setting the compulsory license fees for non-subscription, non-interactive webcasting, a Copyright Arbitration Royalty Panel ("CARP") ruled that "the willing buyer/willing seller standard is the *only* standard to be applied."[3] The Panel explained that the two other factors enumerated in the statute (i.e., substitution/promotion effects on phonorecords, and relative roles of the parties) do not constitute additional standards or policy considerations.[4]

I am in complete agreement that the willing buyer/willing seller standard can and should be interpreted broadly enough to encompass these two other factors and any other consideration that would affect the outcome of a negotiation in the free market. Markets function very effectively to take account of all the considerations that are important to

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[3] *In re Rate Setting for Digital Performance Right in Sound Recordings and Ephemeral Recordings*, No. 2000-9 CARP DTRA 1&2, slip op. at 21 (CARP Feb. 20, 2002) (Report of the Copyright Arbitration Royalty Panel to the Librarian of Congress).
[4] *Id.*

buyers and sellers. By using a benchmark analysis, I avoid the necessity of having to separately value each of the considerations relevant to buyers and sellers, because the market already has done so -- my task is simply to adjust for any relevant differences between the benchmark market and the market at issue here.

B. The Marketplace

I also understand that the willing buyer under this statutory standard is a webcasting service that seeks to make non-interactive transmissions of copyrighted sound recordings to consumers. The willing seller is an owner of copyrights in a single or multiple sound recordings, usually a record company. I further assume that no party has monopoly power, but that the owner of copyrighted sound recordings has, due to the nature of the copyright itself as a monopoly, a unique asset that is different from the bundle of sound recordings offered by other copyright owners.

I also assume that an individual webcaster will seek to obtain the best price that it can in the marketplace and that it might forego providing some digital music services if others are more profitable. Similarly, an individual record company will try to maximize profits across all of its various revenue streams. Such behavior is consistent with the concept of a willing seller of a differentiated product in a competitive market. Thus, for example, the willing seller might set a higher rate in a market than it otherwise would, if sales in that market would substitute for more profitable sales in a different market.

I also assume that both the willing buyer and willing seller in this hypothetical marketplace are commercial entities fully motivated to maximize profits. "Sellers expect to make a profit and will extract from the market what they can, just as buyers will do everything in their power to get the product at the lowest possible price." *Determination*

of Reasonable Rates and Terms for the Digital Performance of Sound Recordings and Ephemeral Recordings, 67 Fed. Reg. 45,240, 45,245 (July 8, 2002) ("67 Fed. Reg. 45,240"). Thus, I do not attempt to set separate rates for noncommercial entities or hobbyists that are not seeking to maximize profit, or even those small webcasters that may be unable to survive without the benefit of a below-market statutory license. As the Librarian has explained, the willing buyer/willing seller standard requires the setting of rates "that a willing buyer and willing seller would have agreed upon in a hypothetical marketplace that was not constrained by a compulsory license." *Id.* at 45,244.

That a rate might cause consolidation in the marketplace for webcasting is neither a bad nor a good thing. It is, however, the way that a free market economy functions. Firms in a free market are free to thrive and free to fail. Almost all markets go through constant changes as firms enter and exit the business. Indeed, a rate that is set too low may have serious economic dangers. By setting the rate too low, inefficient entry may be encouraged, and inefficient levels of production will be encouraged, which can hinder the development of an efficient market. It is also worth noting that setting the statutory rate too high will not necessarily be harmful to the market. If the price is too high, parties can (and are almost certain to) negotiate agreements for rates lower than the statutory standard. Thus, a rate set too high is likely to "self-adjust" because of the sellers' natural incentive to meet the market. But a rate set too low will create permanent distortion because there is no incentive for the buyers to pay extra -- they may obtain the product at the lower rate without any market correction.

C. *The Product*

In evaluating this market, I have understood the product at issue to be a blanket license from a record company "which allows use of that company's complete repertoire of sound recordings." 67 Fed. Reg. 45,240, 45,244. This license includes only a license for the sound recording copyright, not the separate musical works copyright. It is worth noting that this is not necessarily the equilibrium that a free market would have reached. Willing sellers may have refused to license certain sound recordings (for any of a number of reasons), may have required premium payments for certain sound recordings, or may have held back some sound recordings from widespread distribution in order to offer exclusive deals to a single music service.

I also understand the product to be offered to be a license for non-interactive (as that term is defined in the statute) webcasting, including the right to provide such a service through the making of multiple ephemeral copies used to facilitate transmissions and performing copyrighted sound recordings through digital audio transmissions. Although there are two separate rights at issue (reproduction and performance), each with independent value, I have not sought to quantify them separately in this report. It appears that, in the current marketplace, parties negotiate for a single rate to encompass both the public performance and the reproduction rights.

Finally, I am aware that there may be disputes between record companies and webcasters concerning the definition of "non-interactive" under the statute and thus disputes over the scope of services that fall inside and outside the statutory license. I take no position on that legal issue. For purposes of this analysis, I have presumed that non-interactive webcasting does not permit any form of user input to "customize" particular

stations. As noted below, to the extent that the statutory license allows any degree of customization, its value would almost certainly increase and the royalty would have to increase as well.

IV. NEGOTIATED RATES FROM SIMILAR MARKETS SHOULD BE USED AS THE BENCHMARK FOR THE COMPULSORY LICENSE

In the discussion below, I will describe the nature of the supply and demand side of the hypothetical market for blanket licenses to use copyrighted sound recordings. Although the market is hypothetical, the participants are not, and it is possible to gain a very good understanding of the likely behavior of the participants were it not for the compulsory license. By looking carefully at the characteristics of the music services offered in the market, I have been able to derive proposed fee levels and a rate structure for the compulsory licenses that should closely approximate the result of a market negotiation between willing buyers and willing sellers.

I recommend that the Copyright Royalty Board adopt compulsory license fees for non-interactive digital audio transmissions ("NI-DATs") derived from current market negotiated rates for copyright licenses used by music services providing interactive digital audio transmissions (interactive DATs). These benchmarks can be used for the compulsory fee after adjusting for the different characteristics of the two markets. I believe that benchmarking is superior to other approaches that might be proposed in this proceeding or to techniques that economists have used in other contexts. The reason for this is that there are reliable, comprehensive, and statistically meaningful data available on negotiated prices in the market for interactive DATs, which is nearly identical to the

"hypothetical" market for NI-DATs in virtually all respects. As discussed below, where there are differences between the two markets, it is possible to adjust the royalty rates for these differences using basic economic principles. This will minimize the complexity of the modeling used to develop the compulsory fee and make it much easier to focus the analytical efforts and identify a range of reasonableness for the compulsory fee.

In this section, I will explain the rationale for using prices from benchmark transactions to set the compulsory fees. Then, I will explain my choice of the benchmark. Finally, I will discuss other approaches to setting the rate for NI-DATs that I have considered and rejected.

A. Benchmark Rates Satisfy the Willing Buyer/Willing Seller Standard

In its prior decision, the CARP recognized the superiority of actual marketplace agreements as a benchmark for the compulsory fees:

> The Panel believes that the quest to derive rates which would have been negotiated in the hypothetical willing buyer/willing seller marketplace is best based on a review of actual marketplace agreements, if they involve comparable rights and comparable circumstances.

In re Rate Setting for Digital Performance Right in Sound Recordings and Ephemeral Recordings, No. 2000-9 CARP DTRA 1&2, slip op. at 43 (CARP Feb. 20, 2002) (Report of the Copyright Arbitration Royalty Panel to the Librarian of Congress) ("*CARP I*").

As the CARP explained, the use of benchmark agreements is invited by the statute and supported by the reasoning that "because … it is extraordinarily difficult to predict marketplace results from purely theoretical premises, it is clearly safer to rely upon the outcomes of actual negotiations than upon academic predictions of rates those negotiations might produce." *Id.*

The use of benchmark rates solves many of the informational and conceptual problems associated with trying to predict the outcome of an unobserved or "hypothetical" market. A market brings together buyers and sellers and "solves the equations" that specify the willingness of these parties to engage in a transaction at a particular price. The buyers' equation consists of the sum of the willingness to pay of all of the existing and potential customers of a service. Their willingness to pay is dependent, among other things, upon the characteristics of the service, the income of the customers, and the prices of substitutes and complements to the service. The willingness of a seller to offer a service at a particular price is in large measure a function of its costs, the effect of sales of one service on sales of other services sold by the same company, and the intensity of competition in the marketplace both in the short and long run.

In the absence of a benchmark, the Board would need to weigh all of these factors and estimate their numerous and complex interactions and interdependencies. For example, if there were no data from markets where sound recordings were transmitted on the Internet, it would be very hard to estimate from the prices paid in other markets how much consumers would value this functionality. Consequently, it would be very hard to estimate the willingness of an Internet music service to pay for the right to play particular sound recordings, since this is derived from the underlying consumer demand for the music service. Use of a benchmark provides us with a shortcut through most of this analytical and informational thicket and creates a solid foundation for setting the compulsory fee for NI-DATs. It avoids the complexity of analyzing numerous factors in the market, and allows us to focus on only those few factors required to adjust from the known voluntary rates to the statutory rates.

Benchmarks are used in other situations, such as where government agencies set prices in an attempt to emulate the functioning of a competitive marketplace. When tasked with the job of setting regulated rates for cable television not subject to effective competition, the FCC adopted a benchmark approach that simulated the rates that would be charged by comparable cable systems subject to effective competition.[5] The FCC has also relied on benchmarking in setting rates and judging practices of regulated telephone companies, stating that the alternatives to benchmarking are "more intrusive and costly methods of regulation."[6]

B. Contracts for Interactive Digital Audio Transmissions Are the Best Benchmark for the Compulsory NI-DAT Fees

The goal in this proceeding is to set a blanket compulsory license fee for the use of copyrighted sound recordings for non-interactive digital audio transmissions for both subscription and non-subscription services. As the last CARP recognized, if there were negotiated agreements between webcasters and the major copyright owners of sound recordings for the precise types of services at issue, such agreements would likely provide the best available benchmark for setting the market rate. Absent such agreements (and I am informed that no major record label has entered into an agreement for non-interactive webcasting, other than to restate the current rate), the first issue is to determine the most closely analogous market that provides the best benchmark for the market at issue.

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[5] *In re Implementation of Section of the Cable Television Consumer Protection and Competition Act of 1992 Rate Regulation*, 8 F.C.C.R. 5631 (1993) ("*Rate Order*").
[6] *In re Applications of AMERITECH Corp., Transferor and SBC Communications Inc., Transferee*, 14 F.C.C.R. 14,712, ¶ 58 (1999).

Prices in a candidate market will serve as a good benchmark for price-setting in the target market if three conditions are met. First, the candidate market must have similar characteristics to the target market. Second, information on prices in the candidate market must be available and statistically valid. Third, it must be possible to adjust the prices in the candidate market for any major differences between the two markets. Based on my analysis of conditions in the market for interactive DATs and NI-DATs, I believe that all of these conditions are met and the use of this benchmark will generate a compulsory license fee that meets the statutory standard and is consistent with well-established economic principles.

1. Common Characteristics of the Benchmark and Target Markets

The following characteristics are common to both the non-interactive and interactive markets:

1. Similar buyers: The buyers and sellers in these markets are essentially the same -- Internet music services and sound recording copyright owners. Indeed, many of the major buyers in the two markets are the same companies. Music services, such as AOL, Yahoo! and Real Networks, have obtained copyright licenses (directly or through third-party providers such as MusicNet) for interactive DATs from all of the major record companies. These companies also use the compulsory blanket licenses on NI-DATs in order to offer a full range of service options to their customers.
2. Similar sellers: Owners of copyrights in sound recordings are the sellers in both markets. The vast majority of the market for sound recordings results from the

sales of the four major recording companies. Those companies have entered into contracts for interactive DATs and also are compelled to license their sound recordings under the statute at issue in this proceeding. Their willingness to license music in these two markets is affected by similar factors, including the effect that licensing a music service has on other revenue streams, such as the sale of CDs or the receipt of license fees from other types of music services.

3. Similar products: In both the interactive and non-interactive markets, the product being delivered to consumers at any given moment is essentially identical -- a digital audio transmission of a sound recording. The primary difference derives from whether the consumer selects the sound recording or the webcaster selects it.
4. Similar experience for the consumer: Consumers of interactive and non-interactive music services experience service offerings that are identical with respect to most features, including: the types of equipment needed or optimized for listening to music over those services (a computer, broadband access, etc.), the place where the services can be received (generally through a home computer), the range of titles, the option to receive commercial-free service (although non-subscription NI-DAT services have commercials, subscription NI-DAT services generally do not), and information about the songs played. Each service allows the user to listen to music, but not to keep a permanent copy. The commonality of the music experience and the similarity of the transaction allow us to draw inferences about the underlying value of the non-interactive license to the buyers.

2. Abundant and Robust Pricing Data Are Available

The second necessary condition for a good benchmark is that reliable and statistically valid data must be available on transactions in the candidate market. This condition is easily satisfied for the interactive DAT market. I have been given access to contracts between all four major record companies and the music services providing interactive services. These contracts state the terms and conditions of the transactions. Prices are stated explicitly in the contracts, and for the most part they can be easily summarized and compared across different companies. Also, as I will explain in greater detail in Section 5 below, the statistical properties of the data are very good and allow for strong inferences to be drawn about the level of prices in the market as a whole.

3. Few Differences Exist Between the Benchmark and Target Markets

1. Interactivity: There is one major difference between the benchmark and the target markets. The benchmark music services give the listener the ability to choose which titles to listen to at any point in time. All of the major music services that I have relied on for benchmarking provide their customers with a large music library from which they can select songs, build playlists, customize their listening experience (e.g., shuffling or repeating songs), or use various programming aids to identify and select music titles. By contrast, the music services that adhere to the requirements of the compulsory license stream music on channels targeted to particular genres, themes, or eras. Listeners cannot select particular songs, but rather can pick from many sub-genres of music, which will be provided to them upon request. In Section VI below, I will

explain how I adjusted the benchmark music licenses to account for the restriction on interactivity contained in the compulsory license.

2. Tethered downloads: Most of the benchmark interactive music services give listeners the option to download music to their computer. These downloads are "conditional," which means that they will only play for as long as the customer subscribes to the service. I have not attempted to measure the value placed on conditional downloads to a fixed computer. Interactive music services do not charge consumers separately for the ability to receive tethered downloads, and I have found no evidence showing whether or by how much this option is separately valued by consumers. In part, it seems to be a benefit to the music services, which can save on Internet capacity by not having to stream music to customers whenever they listen to songs. Indeed, Yahoo! provides tethered downloads rather than on-demand streaming as the default option to their customers, which means that music is not streamed unless the customer actively selects this option. In any event, to the extent that tethered downloads provide some additional value to consumers, that value is already captured in the market price and therefore adjusted for in my analysis.

3. Portability: There are some interactive music services that offer users not only the ability to stream music to their computers and conditionally download such music, but also to transfer such conditional downloads to portable devices, such as certain mp3 players. This portability feature significantly changes the consumer experience. No longer are the users able to listen to music only over their personal computers; they can also take the music with them and listen to it wherever and whenever they want. It is clear that the market places a premium on such portability. Music services pay

significantly higher royalty rates for the portable (as opposed to non-portable) interactive DATs, and consumers generally pay more in the marketplace for such services.

Because of the significant difference in consumer experience, I have generally excluded such portable services as a relevant benchmark. Instead, in analyzing the benchmark market, I have focused on data available for those interactive DAT services that are non-portable, i.e., that prohibit consumers from transferring music from their computers and generally require consumers to listen to music over their personal computer or another home device. Such non-portable services are much closer to the market for non-interactive services.

4. Holdbacks: I have excluded from consideration one other difference between the licenses for the interactive DATs and the compulsory license for NI-DATs. The contracts for the interactive DATs are not blanket licenses. Rather, all of the record companies retain the right to withhold certain titles from the licensees for different purposes. As a result, listeners will not be able to play some or all titles of particular artists on demand. These holdback provisions may be the result of a popular artist's ability to control distribution of its music in digital form. For example, Rhapsody's online Frequently Asked Questions responds to "Why are some artists not listed on Rhapsody?" with "If you can't find certain artists in Rhapsody, we may not yet have the rights to offer their music."[7] The Beatles are an example of a band not available via on-demand streaming. By contrast, a user of a non-interactive service under the compulsory

[7] The complete response to the question is available on Rhapsody's Customer Support website at http://reclisten.custhelp.com/cgi-bin/reclisten.cfg/php/enduser/std_adp.php?p_faqid=134&p_created=&p_sid=IRp145Th&p_lva=1021574031&p_sp=&p_li=cF9zcmNoPTEmcF9zb3J0X2J5PSZwX2dyaWRzb3J0PSZwX3Jvd19jbnQ9NCZwX3Byb2RzPSZwX2NhdHM9JnBfcHY9JnBfY3Y9JnBfc2VhcmNoX3R5cGU9YW5zd2Vycy5zZWFyY2hfbmwmcF9wYWdlPTEmcF9zZWFyY2hfdGV4dD1iZWF0bGVz&p_prod_lvl1=&p_prod_lvl2=&tabName=&p_topview=1

license can listen to a "Beatles" station that plays a substantial number of Beatles songs (so long as it complies with the sound recording performance complement requirements). In other cases, the record company may exercise its right to hold back certain sound recordings in order to release that sound recording exclusively to one service or in one particular form (e.g., on CD, but not over an Internet music service).

The holdback provision in the negotiated contracts reduces the value of this license to the music services, because their subscribers will not be willing to pay as much for access to a music library that is missing some titles from the "shelves." Certainly the buyer of the license would be willing to pay to have access to all titles. This means that the benchmark license fees for interactive DATs are below the level that would be negotiated for a license without holdbacks. Since I have not made this adjustment, there is good reason to believe that my recommended rate for the compulsory license is conservative.

C. Other Possible Benchmarks Would Not Be Suitable

1. Rates for Copyrighted Musical Works

In the previous CARP proceeding, the music services proposed a fee for sound recordings derived from the fees charged by the performance rights organizations ("PROs") for public performances of copyrighted musical works. *CARP I* at 27-32, 40-42. They argued that since rights to the musical work and the sound recordings both were essential to public performances, it was reasonable to compare the fees paid for the two rights. Further, the music services claimed that the fees charged by the PROs should be expected to be greater than the appropriate compulsory fees for non-interactive DATs. *Id.*

The first response I have to this hypothesis is that it does not fit the facts. In several markets where the two copyright fees are negotiated freely among the parties, the license fees for the sound recordings are much higher than the license fees charged for the musical work.[8] The music services providing interactive DATs voluntarily agreed to license fees for sound recordings that are in the range of [redacted] By comparison, the fees paid for the right to perform musical works by interactive services are substantially less.[9]

These facts do not support the theory that the license fees for the two rights should be comparable. Rather, I believe that economic theory supports the notion that the fees paid to two key factors of production (such as the musical work and sound recording) do not necessarily bear any close relationship to each other. The primary reason for this is that the *ex ante* value of the two factors of production will depend on their scarcity value. To the extent that popular recording artists are "scarcer" than musical composers, the returns to the recording artists will be higher. By analogy, the profit shares of screenwriters, actors, and directors (all of whom are "essential" to production of a movie) will be very hard to predict based on a simple formula. The

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[8] There is currently a dispute concerning the amount that PROs will be paid by interactive music services. Sarah McBride, "Music Royalty Talks Hit Impasse," *Wall St. Journal*, at B2 (Aug. 26, 2005). Although ASCAP at least has published rates for performance of musical works by interactive services, the dispute centers around whether a "mechanical" fee must be paid because a reproduction of a copyrighted musical work occurs in the transmission of an on-demand stream. According to published reports, the current dispute ranges from 6.9% (which the interactive services have offered) to 14% (which the PROs are requesting). Even under the highest amount that has been suggested by the PROs (and rejected by the interactive music services), the PROs would receive dramatically less than the sound recording copyright owner. In the only marketplace agreement for this type of license of which I am aware, the PROs provided a license to Streamwaves with a royalty rate that was the greater of 10% of revenue or $1.00 per subscriber. *See* September 21, 2001 press release, available at http://www.nmpa.org/pr/streamwaves.html. This again is far less than the copyright owners in sound recordings receive from interactive music services.

[9] Information about acquiring license fees from the three major publishing firms (ASCAP, BMI, and SESAC) for Internet webcasting is available at their respective websites: http://www.ascap.com/weblicense/license.html; http://www.bmi.com/licensing/webcaster; and http://www.sesac.com/licensing/internetLicensing.asp.

market will compensate a particular actor more than a director or screenwriter if attendance at the movie increases substantially when that actor plays the lead role. It would be improper to second guess the market and conclude that the compensation for actors, writers, and directors should be the same because all are needed to produce a movie.

2. Rates for Use of Sound Recordings for Customized Web Radio Broadcasts

Another possible benchmark for the NI-DAT fees is the fees negotiated for customized web radio services, which do not fall within the definition of a non-interactive service. There are, or at least have been, a number of custom web radio services that allow the user to interact with the radio station by rating the artists or songs or by controlling the play of music by pausing or repeating tracks. User interaction with these digital audio transmissions removes the service from eligibility for the compulsory license and requires the music service to negotiate licenses with the copyright holders to transmit the sound recordings to their customers.

Although the use of copyrighted music is similar between customized radio and NI-DATs, this does not mean that the license contracts for the customized radio services should serve as a benchmark for the compulsory fees set in this proceeding. The negotiated rates are not a good measure of a price that would emerge from a free and undistorted market where willing buyers and willing sellers were negotiating for the rights to use copyrighted sound recordings. Rather, for two reasons, the negotiations in this market are strongly influenced by the rates previously set by the CARP for NI-DATs.

First, at least one custom radio service has argued that its service falls within the

scope of the current statutory rate for non-interactive services, and litigation is pending over this issue. To the extent there is uncertainty about whether a particular service falls inside or outside of the statutory rate, any negotiated agreement for the use of such music will be affected by the cloud of litigation. Second, even if the legal status of the custom radio services were perfectly clear, the fact that they are close substitutes for the non-interactive services means that their prices will be strongly influenced by the compulsory fees. If the copyright holders try to set a much higher price for a nonstatutory customized service, the music services will simply not offer these services but instead limit their offerings to ones that can be provided under the compulsory license. This has the effect of driving down the rates that a willing seller can negotiate for custom radio services; this effect would not exist in a truly free market. *See* Testimony of Mark Eisenberg at 17; Lawrence Kenswil at 12; Stephen Bryan at 13; and Ken Parks at 9.

3. Compulsory License Fees for Other Digital Music Services

Compulsory license fees have also been set under the provisions of the Copyright Act for "preexisting subscription services," such as residential subscription services providing music over digital cable or satellite television. *In re Determination of Statutory License Terms and Rates for Certain Digital Subscription Transmissions of Sound Recordings*, No. 96-5 CARP DSTRA (CARP Nov. 28, 1997); *In re Rate Adjustment for the Satellite Carrier Compulsory License*, No. 96-3 CARP-SRA (CARP Aug. 28, 1997) ("*Satellite CARP*"). These rates were not established in the free market. Moreover, the statutory standard under which such fees have been set is different than the "willing buyer-willing seller" standard that must be applied to the non-interactive music services

at issue in this proceeding. Consequently, the license fees for these services cannot be used as a benchmark.

4. The Current Rates

The last possible benchmark is the current rates, which were originally set by the Librarian following the last CARP, but which were pushed forward, with some modifications, by both sides for 2003 and 2004. The agreement in 2003 and 2004 to extend these rates does not provide a useful benchmark. First, that agreement does not reflect a negotiation in a marketplace that is unconstrained by the statutory license, and therefore comes nowhere near meeting a "willing buyer/willing seller" standard.[10] Second, as explained in the Statement of John Simson, the agreement occurred during a period when the last CARP was still on appeal and it made little sense to re-litigate the same issues over again.

V. RECENT COPYRIGHT AGREEMENTS IN THE INTERACTIVE DIGITAL AUDIO TRANSMISSION MARKET

I have been provided with the contracts entered into between the four major recording companies (EMI, Warner Music Group, Universal Music Group, and Sony BMG) and the Internet music companies offering interactive music services. In the analysis below, I have focused on the contracts that are currently operating between willing buyers and willing sellers, with the exception of some contracts that are subject to restrictions that may affect their use in this proceeding. I have also excluded those

[10] *Cf. Satellite CARP*, slip op. at 30 (refusing to select a highly comparable service as the benchmark, in part, because "the compulsory rates prescribed under [that] section [ ] are not fair market rates and cannot be utilized as a benchmark for a fair market valuation").

contracts which are specifically limited to, for example, college students, rather than the general population.

A. Summary of Information Found in the Contracts

I have looked at approximately 40 contracts from the four major music studios that were executed between 2000 and 2005, covering uses of sound recordings during the period 2000 through 2006. [[redacted]]

I have summarized the key contract terms of the current agreements between the four major music companies and the interactive DAT services in Table 1 of Appendix A.

For seventeen contracts currently in effect,[11] Table 1 lists the dates when the terms of each contract become effective and expire and the [ ] components of the rate structure stipulated in the contract. In addition, the average rate [ ] is given at the bottom of the table.

B. Contrast Between Negotiated Contracts and Compulsory License

The negotiated contracts in the interactive market provide the parties with the same basic rights and obligations as the compulsory license (i.e., the right to stream music in exchange for the payment of royalties). The negotiated contracts, however, contain many additional provisions of value to copyright owners. These differences between the market licenses and the statutory license are presented and explained in the table below.

[11] Because the contract terms have changed over time, I restrict my analysis to the contracts currently in effect. The most recent agreements best represent the current market for interactive DAT services. [ ] Thus, to the extent that my analysis weights contracts signed two years ago the same as contracts signed recently, it is conservative.

Table 5.1: Differences Between Market Licenses and the Statutory License

Special Features of Contracts for Interactive Services	Explanation	Benefit to Copyright Holder	Comparison to Compulsory License
Regular contract does not allow music to be used on a mobile or portable device	The major music services pay substantially more for portability	Limits substitutability for paid downloads or CDs	Can be used for mobile streaming service without extra payment (currently)
Promotional Consideration	Agreements with music services contain detailed promotional provisions	These promotions are guaranteed and individually negotiated	Provides no special promotional benefits
Advances	Guaranteed substantial payments from licensee	Reduces risk of unsuccessful venture by licensee; ensures that negotiations are only with serious business partners	Provides no advances, other than low minimum fees, to copyright owners
Data Reports	Licensees provide detailed reports regarding royalties and consumers' usage of sound recordings	Enforcement of royalties; valuable information for business development purposes	Data reports contain only minimal information of limited use to copyright owners
Audit Rights	Annual right to review licensees' books and records; [redacted] underpayment requires licensee to pay for audit	Allows proper enforcement of royalty obligations	Copyright owners do not have audit rights
Stream Security	Requires digital rights management software to protect against illegal or unauthorized downloads	Prevents/limits unauthorized copying or unpaid uses	Streams can be captured by end-user and converted to MP3 without payment of copyright fees
Holdbacks	Copyright holder reserves right to holdback some titles from licensees	Allows copyright holders to control release of music and obtain more revenue from sales of certain titles	Blanket license does not allow any music to be held back

As a general rule, these features in the voluntary agreements between the record companies and the music services are not incorporated into the statutory license. Because

the statutory license lacks some of the types of consideration bargained for in the negotiated agreements, the royalty rate for the statutory license should be relatively higher as a result (compared to a rate derived from the benchmark agreements without accounting for the absence of this consideration). If copyright owners were to negotiate in the free market, one would expect them to license non-interactive services only if they received terms such as those noted in the table or if they received some other valuable consideration, such as a higher royalty rate.

I have not, however, sought to quantify the value of the additional consideration contained in the benchmark agreements and have not adjusted the benchmark rates to account for the absence of that consideration. Since I have not quantified that increase, the compulsory fee that I derive in the subsequent discussion is conservative (i.e., lower) than it otherwise would be.

VI. ADJUSTMENTS CAN BE MADE TO THE BENCHMARK FEES TO ESTABLISH RATES FOR THE COMPULSORY LICENSE

Selecting a benchmark is the first step in developing the proper copyright fee. As discussed above, the benchmark provides a useful starting point because it captures what a willing buyer and willing seller would agree to in the marketplace. The next step is to make appropriate adjustments to the fee to account for differences in the two markets -- in this case the interactive and non-interactive DAT markets.

A. *Overview*

Below I provide a more detailed discussion of the economics behind making some of the adjustments. An overview of the steps can be provided in simpler terms.

- First, I will consider what rate *structure* would likely be negotiated between willing buyers and sellers in the non-interactive DAT market, using the interactive DAT market as a benchmark. I conclude that the appropriate royalty is the greater of a per subscriber rate (where applicable), a percentage of revenue, and a per play rate.
- Second, I determine the relationship between the license fees and the prices charged to consumers in the market for interactive music services. I apply that ratio to the consumer prices in the market for non-interactive services in order to derive an appropriate license fee for that market. Before doing so, I adjust the consumer prices to ensure that those prices reflect only the difference in value resulting from the absence of interactive functions.
- Third, having made that adjustment, I then consider another potentially relevant difference between the two markets that affects the per play rate. Because of the more passive listening experience of non-interactive services, non-interactive services may be used more than interactive services. Although such differences have no impact on a per subscriber minimum or a percent of revenue calculation, they do have an impact on the per play rate. To account for this difference, I adjust the per play rate down (to the benefit of webcasters).
- Finally, I examine a fourth factor that may impact the royalty rates for the two different types of services -- the possibility that one may have a greater substitution impact on CD sales. Although I find no evidence to support such an impact, my

analysis demonstrates that, even if a significant differential substitution effect could be proven (e.g., even if interactive services replace two CD sales per year and non-interactive webcasting replaces none), a significant increase in the current statutory rate is warranted.

The approach described above has two virtues. First, it accounts for the observable differences between the two markets. In the last CARP proceeding, copyright owners submitted a variety of "corroborating" agreements to the Panel, but made no effort to explain their relevance or to adjust the royalty fees in those agreements to account for differences in the statutory license. This approach accounts for those differences and thus provides a reliable benchmark. Second, it is my view that this approach comports with the way that willing buyers and willing sellers would actually think about negotiating agreements in the marketplace. As explained in the testimony of Stephen Bryan at 10-11, record companies use existing agreements in closely analogous markets as benchmarks in evaluating the proper copyright fee in other markets. They also seek to account for differences in functionality (such as portability) that may increase or lower the appropriate price. And they also consider the impact that a particular service may have on other revenue streams through substitution. Thus, I believe my analysis accurately captures the thinking of the willing buyer and willing seller and provides a reasonable approximation of the fee that would be negotiated in the marketplace.

B. *Derivation of a Rate Structure for the Non-Interactive Market*

In order to create a fee structure for the compulsory license, I propose adopting [a three-part fee structure which requires the music service to pay the greater of (i) a fixed percentage of revenue, (ii) a per subscriber fee, or (iii) a per play fee. [ ]

In my opinion, it is essential to adopt this parallel rate structure for the compulsory license fee, because it is the only way to capture the willing buyers' and willing sellers' recognition of the uncertainty about marketplace developments over the next several years. [ ]

The holders of the copyrights in sound recordings face significant uncertainty as to the way in which their sound recordings will be used. The number of plays, the popularity and vintage of the recordings played, and the value of the music services to the customers are all difficult to predict well in advance of the end point of the contract. [

Through the percentage of revenue, the record companies ensure that they will receive a share of royalties that properly compensates them for their valuable copyrighted material, [ ] The per

play and per subscriber minima protect the record companies from significant use of their music that is priced at below-market prices to consumers (either because prices are not at a long run equilibrium or because a music service wants to attract consumers to its site with low prices so that it can earn a profit from the consumer in other ways, e.g., selling the consumer non-music products and services). For example, Yahoo! has priced its music services well below its competitors' rates in order to attract customers to its portal.[12] The per play and per subscriber components of the fee structure protect record companies in such situations.

[[redacted]

Because [[redacted]] the business justification for this structure is so compelling, it should be adopted as the rate structure for the statutory license. It would not be proper to cherry-pick only one or two elements of the three-part rate structure without analyzing

[12] *See* interview with Dave Goldberg, a Vice President and GM at Yahoo!, Inc. from May 10, 2005 available at www.paidcontent.org/pc/arch/2005_05_10.shtml#013667. I understand that Yahoo! recently raised its prices to bring those prices in line with those of its competitors.

and potentially adjusting the applicable rates. [[redacted]]

In the sections that follow, I will discuss how to derive from the contracts in the interactive market the rate in the non-interactive market for each of the three elements of this fee structure, beginning with the per subscriber rate. The adjustments to the interactive market rates proposed below have meaning primarily in the context of this rate structure. If the Board were to select a different rate structure, different adjustments would be appropriate.

C. *Derivation of a Per Subscriber Rate*

Common sense suggests that if willing buyers and willing sellers agreed to a royalty rate in the market for interactive music services, and if the value to consumers of non-interactive services is, for example, 25% lower than the value to consumers of interactive music services, a market-based royalty rate for non-interactive services ought to be 25% of the royalty rate set in the interactive market. Common sense is, in this case, essentially correct. The economic theory which demonstrates the conditions under which this is true, however, requires some explanation. In the following sections, I will provide

that explanation and outline the adjustments I have made in order to derive royalty rates in the non-interactive market from the rates freely negotiated in the interactive market.

[I will begin by deriving the per subscriber rate for non-interactive services, and in later sections will separately derive the percentage of revenue rate and the per play rate.

1. Calculating the Ratio of License Fee to Consumer Price

We can observe in the market the subscription prices charged to consumers for interactive music services, and we can extract from the agreements between record companies and interactive music services the per subscriber royalty rate to which the parties in that market agreed. Simple math allows us to calculate the ratio between the amount of the average price charged to subscribers by music services, and the amount of the average per subscriber royalty paid by music services to record companies.

We also can observe in the market the average subscription price charged to consumers for subscriptions to non-interactive music services. If we assume that the ratio of subscription price to per subscriber royalty is the same in both the interactive and non-interactive markets, we can then calculate what the per subscriber royalty rate should be in the non-interactive market. For example, if the average subscription price paid by consumers for an interactive music service is $9 per month, and the average per subscriber royalty paid to a record company is $3 per subscriber (a 3-to-1 ratio), then we can predict that the per subscriber royalty that would be negotiated in the non-interactive

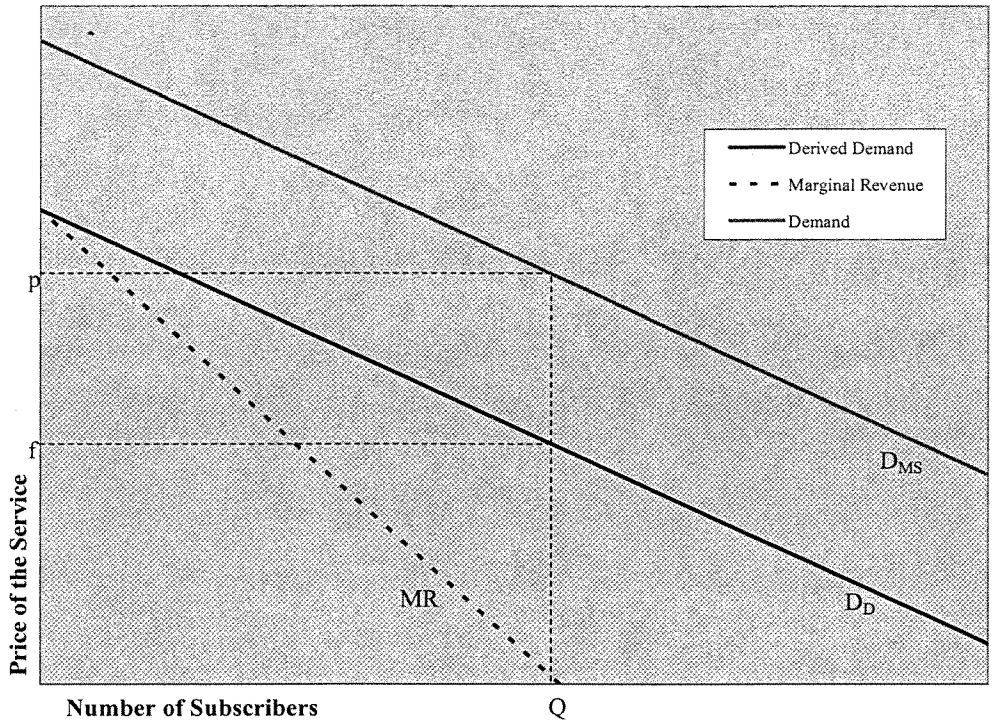
market would be $1 per subscriber if the average monthly subscription price charged to consumers for non-interactive services is $3 per month.

The key to this analysis, of course, is the assumption that the ratio of consumer price to royalty rate would be the same in both markets if the royalty rate were freely negotiated. I believe this assumption is correct because the sensitivity of demand to changes in price (i.e., demand elasticity) in both markets is likely to be very similar.

To understand why this is so requires a basic understanding of how prices are set for information goods in a free market. For these types of goods, or for other goods with very low marginal cost, prices are set as a function of demand and demand elasticity. Elasticity of demand refers to the effect that changing price has on the quantity sold. The more elastic the demand, the more the percentage of quantity sold diminishes as the percentage of price is raised.

In Figure 1, I have drawn the demand curve for the interactive music services, which is labeled as D_{MS}. I measure output in the industry as the number of subscribers. Therefore, the horizontal axis measures number of subscribers and the vertical axis measures monthly subscription price per subscriber. Demand is downward sloping, which is the nature of virtually all markets. (For exposition purposes, I am using a linear demand curve.)

Figure 1: Derived Demand Curve for Interactive Music Services



From the demand curve for interactive music services, one can derive the demand curve for copyrighted sound recordings. This type of demand curve is referred to in economics as a "derived demand," because it is the demand for an input in a production process, and is derived from the underlying demand for the product or service sold to consumers. It is particularly apt in this context, because sound recordings are an essential and non-substitutable input for music services. In economic parlance, interactive music services have a "fixed-proportions production function," meaning that every "unit" of output sold to a consumer requires a "unit" of input bought from the record companies.

As a consequence, music services cannot substitute away from the copyrighted music as its price increases.[13]

On Figure 1, the line beneath D_{MS}, which is labeled as $D_{D,}$ is the derived demand for the copyright license. This is the demand by the music services for a license to play copyrighted music, where the license fee is paid on a per subscriber basis. I have drawn the derived demand curve parallel to the demand curve for music services for two reasons. First, as discussed above, sound recordings are a non-substitutable input for music services -- thus, a change of one unit in the demand for music services results in a change of one unit in the demand for copyrighted material. Second, I assume that any change in the copyright fee is passed on dollar-for-dollar to consumers. This is the normal assumption in a competitive market with constant average and marginal cost. The distance between the two demand curves is the amount that would cover the other production costs of the music services, including a reasonable profit margin. In other words, the demand by music services for copyrighted music is essentially the same as the

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[13] That consumer demand (and thus consumer price) should provide important information about the value of an underlying fixed factor also is a relatively basic concept. The value of interactive and non-interactive music services is a direct function of the music itself. This has been recognized in the context of licensing of musical works:

> What retail customers pay to receive the product or service in question (in this case, recorded music) seems to us to be an excellent indicator of its fair market value. While in some instances there may be reason to approximate fair market value on the basis of something other than the prices paid by consumers, in the absence of factors suggesting a different measure the price willing buyers and willing sellers agree to in arm's length transactions appears to be the best measure.
>
> It is true without doubt that to make the music available to its customers, the retail seller must incur expenses for various processes and services not provided by the owner of the music . . . . However, this is in no way incompatible with the proposition that retail revenues derived from the sale of the music fairly measure the value of the music. The customer pays the retail price because the customer wants the music, not because the customer wants to finance the laying of cable or the launching of satellites.

United States v. Broadcast Music, Inc., 316 F.3d 189, 195 (2d Cir. 2003) (footnote and citation omitted).

consumers' demand for music services using that work, less the music services' costs of production (other than the copyright fee itself) and a reasonable profit.

Thus, at any given level of output, the price point on the derived demand curve is the amount the music services are willing to pay for the license, while the price point on the demand curve for the music service is the amount that subscribers are willing to pay for the service. From these demand curves we can show how prices in the market will be set.

The line drawn in Figure 1, labeled as MR, is the marginal revenue curve of the derived demand curve. Marginal revenue is the change in revenue with respect to a change in output. As output increases, customers' willingness to pay declines, i.e., market price declines, and the revenue collected from all units sold in the market will fall. This is the reason why the marginal revenue curve is more steeply sloped than the demand curve. Standard economic theory shows that a firm will maximize profit at the level of output where marginal revenue equals marginal cost. In this market, there arguably is little or no marginal cost for the record companies associated with extending the copyright license to an additional subscriber. Therefore, the optimal price of the license from the copyright holder's standpoint is where marginal revenue is zero, i.e., where it crosses the horizontal axis. The level of output where this is achieved is labeled in Figure 1 as Q. Corresponding to this equilibrium level of output, the equilibrium license fee is labeled as "f." And the corresponding price that consumers will pay to the music service at this output level is labeled as "p."

If the same graph was drawn to depict optimum pricing of the copyright royalty fee in the market for non-interactive music services, the demand curves would appear

somewhat lower on the graph. I believe that it is reasonable to assume that the demand elasticity in the interactive and non-interactive markets would be very close in the relevant range of the demand curves.[14] Thus, the consumer demand curve and the derived demand curve in the non-interactive market would have essentially the same relationship to each other as the corresponding demand curves in the interactive market. Setting the optimum price for the license fee and observing the resulting price to consumers based on these demand curves, in the same manner that I described above, would yield an equilibrium license fee and a corresponding consumer price that would be lower than the prices in the interactive market (because the demand curves are lower).

The conclusion that the ratio of license fee to consumer price is the same in both the interactive and non-interactive markets allows us to derive an appropriate market-based license fee for the non-interactive market. As shown in Table 1 of Appendix A, the average per subscriber copyright fee in the interactive market is [[redacted]] (corresponding to "f" on Figure 1). Furthermore, the average retail monthly subscription price is $8.69 on a month-to-month contract and $7.88 on an annual contract. *See* Table 2 in Appendix A. The average monthly subscription price, therefore, is $8.29 per month (i.e., ($8.69 + $7.88)/2 = $8.29) (corresponding to "p" on Figure 1). The ratio of the fee to the average

[14] Although there are many factors that can influence demand in this market, it is reasonable that the two services, which are nearly identical in virtually all respects save one, would have similar demand elasticities. At bottom, the music services are selling the same sound recordings in both markets, and it is therefore entirely logical that demand elasticity is very similar. Confirming this, there is a great deal of evidence in the marketplace (based on agreements between the major record labels and a wide variety of digital music services) that record companies receive a similar (though not identical) percentage of the retail prices of services the sell this copyrighted material. That is further evidence that the demand elasticities of similar music services should be relatively close in value. Note that this assumption neither redounds to the benefit of the record company or to the services. If demand elasticity were to differ significantly between the two markets, it could increase the copyright fee or decrease it.

monthly subscription price is approximately [[redacted]].[15] Knowing the ratio of license fee to consumer price is [[redacted]] in the interactive market, we can apply that same ratio to solve for the license fee in the non-interactive market if we know what subscription price is charged to consumers in the non-interactive market.

2. Calculating the Value of Interactivity

Subscription prices for non-interactive services exist in the current marketplace. However, those prices may reflect differences between interactive and non-interactive services beyond merely the presence or absence of interactivity. Factors such as sound quality and the number of channels offered might account for, or at least influence, the difference in the subscription rates observed in the market for interactive and non-interactive music services. For the purpose of this analysis, we want to use a subscription price that reflects only the absence of interactivity. It is the presence or absence of interactivity which determines whether the use of a copyrighted digital sound recording falls within the statutory license. And for that reason, the foregoing analysis of how prices would be set based on demand elasticity posited demand curves where the difference in demand resulted from the value of interactivity. Stated differently, if we are going to use the interactive market as our benchmark for setting fees in the non-interactive market, we should compare apples-to-apples -- that is, we should compare based on services that are highly similar except for interactivity.

I used two methods to compute the effect of non-interactivity on the demand (and therefore the price) for music subscriptions. First, I conducted an econometric analysis of demand in order to estimate the added value obtained by consumers from "interactivity."

[15] The correct number is actually [[redacted]] Decimals are carried throughout the calculations made in this paper, but are rounded in the text.

Second, I estimated the simple average difference in retail rates for the music services that offer service in both markets, i.e., a non-interactive, radio-type service and an interactive on-demand service. The results of the regression and the simple average provide an adjustment factor for transposing the market-determined interactive DAT copyright fees to the non-interactive market.

I used a hedonic demand model to isolate the value of interactivity to consumers of online music services. The nature of a hedonic model is to use

> measures of the quality of a product as independent variables instead of measures of the market for that product… Hedonic models are most useful when the product being analyzed is heterogeneous in nature because we need to analyze *what causes products to be different and therefore to have different prices.*[16]

The model used data on different music services, and estimated the effects on prices of the several variables, including: the number of radio stations; interactivity; ability to download to portable device; and sound quality. The results of the model are summarized in Table 6.1 below.

[16] A.H. Studenmund, *Using Econometrics*, Fourth Edition, 2001, at 404 (emphasis added).

Table 6.1. Regression of Subscription Price on Service Characteristics

Dependent Variable: Logarithm of Monthly Price

Variable	Coefficient	Standard Error	T-Value
Intercept	1.74	0.13	13.06
Log(No. Radio Stations)	-0.08	0.07	-1.17
Square of Log(No. of Radio Stations)	0.009	0.008	1.02
Interactivity	0.60	0.13	4.5
Download to Portable Device	0.48	0.19	2.57
Sound Quality	-0.34	0.38	-0.88

No. of Observations: 30
Adjusted R-Squared: 0.71

Note: Regression also included dummy variables for Digitally Imported's service and BellSouth's 1.99 Webtunes Gold service.

The key result is the coefficient on interactivity, 0.60, which is significant at the 99% confidence level. The interpretation of this coefficient is that interactivity raises the price of an online music service by 60% above the level of a non-interactive service that is identical in every other respect. An equivalent way of stating this result is that the ratio of the price of a non-interactive service to a comparable interactive service is 0.63.[17]

A simple "apples-to-apples" comparison of the major online music services' offerings yields a similar adjustment. As shown in Table 6.2, the simple average of the ratio of the prices of the non-interactive to the interactive options of the major music services is between 0.53 and 0.60 (depending on whether monthly or annual subscriptions are compared).

[17] If the price of the non-interactive service were $1.00, then the regression would predict that the price of the interactive service would be $1.60. The ratio of the two prices 1.00 ÷1.60 is 0.63.

Table 6.2. Comparison of the Subscription Price of Internet Radio vs. On-Demand Service

Row	Music Service	Monthly Subscription Price	Annual Subscription Price
(1)	Yahoo!'s LaunchCast Plus	$3.99	$2.99
(2)	Y! Music Unlimited	$6.99	$4.99
(3)	Ratio of (1) to (2)	0.57	0.60
(1)	MusicMatch Gold	$4.95	$2.95
(2)	MusicMatch On Demand	$6.99	$4.99
(3)	Ratio of (1) to (2)	0.71	0.59
(1)	Rhapsody Radio	$4.99	$3.33
(2)	Rhapsody Unlimited	$9.99	$8.33
(3)	Ratio of (1) to (2)	0.50	0.40
(1)	Radio Free Virgin Royal	4.95	NA
(2)	Virgin Digital	7.99	NA
(3)	Ratio of (1) to (2)	0.62	NA
	Average of Ratios	0.60	0.53

Notes:
LaunchCast includes customized features that may fall outside the compulsory license.
Source: Prices listed on the Internet for these services as of 10/21/05.

These two methods to determine the value of interactivity yield a factor ranging from .53 to .63 of the fees in the interactive market. I propose using an adjustment factor of .55, which is toward the lower end of this range. This adjustment factor should be interpreted as the amount by which the observed per subscriber fees for the interactive DAT market should be multiplied to yield the compulsory license fees for NI-DATs.

3. Calculating the Per Subscriber Fee

I can now recommend an appropriate compulsory license fee, on a per subscriber basis, for subscription non-interactive DAT services. I believe that it is appropriate to adjust the per subscriber fee in the interactive DAT market to a corresponding per subscriber fee in the non-interactive DAT market using the demand adjustment factor to determine the appropriate consumer subscription price in the non-interactive market and then applying the same ratio of license fee to subscription price that exists in the interactive DAT market.

As shown in Table 2 in Appendix A, the average retail monthly subscription price for subscription interactive DAT services is $8.69 on a month-to-month contract and $7.88 on an annual contract, yielding an overall average fee of $8.29 per month. If we apply the adjustment factor calculated above of .55, the subscription price for a non-interactive service that is in all other respects comparable to the interactive services is $4.56 per month. The analysis at the outset of this section showing that per subscriber license fees in the interactive market are [[redacted]] of the subscriber price yields a calculation that the fee which would be negotiated between a willing buyer and willing seller in the market for NI- DATs is [[redacted]]

This analysis is conservative in several respects. First, because I calculated the ratio of license fee to consumer price in the interactive market using per subscriber minima from a range of contracts entered into over a three-year period, rather than only the most recent contracts, the fee ratio will not reflect the fact that, in many cases, the per subscriber minima is increasing in more recent agreements. Second, the preceding analysis applies the [[redacted]] factor while assuming the subscription price in the non-

interactive market will remain unchanged. In reality, this is a very conservative assumption, because it is likely that the copyright fee increase will be passed on to consumers.[18] Third, many of the interactive DAT services include, with the purchase price, access to non-interactive DAT services such as those at issue in this proceeding. To the extent that subscribers to the interactive DAT services use their non-interactive components extensively, the adjustment factor I have developed above may greatly understate the value of non-interactive services and the value of copyright licenses necessary to provide those non-interactive music services. In short, the ratio of the fee to the price used for this analysis may be too low, and the consumer subscription price used for this analysis may likewise be too low. A higher ratio applied to a higher consumer price would, of course, yield a higher per subscriber license fee.

D. Derivation of a Percentage of Revenue Rate

When it comes to setting the percentage fee for the non-interactive market, there are two choices. The first is to import the actual percentage of revenue fee observed in the contracts in the interactive market -- [[redacted].] This would be reasonable, in my opinion. If, as I have said, the ratio of the license fee to the subscription price charged to consumers is the same in the interactive and non-interactive markets, the same percentage of revenue fee would be charged in both markets. That is because the actual amount paid on a percentage of revenue basis would be self-correcting, i.e., if the consumer demand for non-interactive music services is lower than the consumer demand for interactive services, the non-interactive music services will

[18] For the reasons discussed in section VI.F.1 of my testimony, the prices charged to consumers in the market for non-interactive services may affect the prices charged in the market for interactive music services. An increase in the subscription price for non-interactive services may allow music services to raise subscription prices by some degree in the interactive market.

earn less revenue and the license fee paid to record companies, in absolute dollars, will decrease by a commensurate amount.

Thus, there is a good argument that the percentage of revenue applied in the interactive market should simply be adopted for the non-interactive market. A more conservative approach, however, would be to derive the percentage of revenue fee based on the ratio of the per subscription fees to the retail price. As stated above, the per subscriber license fee is [[redacted]] and the average monthly subscription price is $4.56, resulting in a percentage of revenue of [[redacted]] To be conservative, I propose using [[redacted]] for the percentage of revenue component of the compulsory license.

E. Derivation of a Per Play Rate

The third component in the fee structure is the price per play. [[redacted]]

Applying the methodology employed earlier, it is appropriate to set the per play rate for the non-interactive market by maintaining in that market the same ratio of license fee to consumer subscription price that exists in the interactive market. Since I have

determined that value to consumers of a non-interactive service is 55% of the value of an interactive service, in order to maintain the same ratio of license fee to consumer subscription price employed in earlier sections of my testimony, [ ]

There is an alternative market outcome, however. Evidence exists indicating that use of non-interactive services by subscribers or users is greater than the use made of interactive services. That is, users of non-interactive services may on average spend more time listening to music on the service, and therefore on average may listen to more "plays," than subscribers to interactive services. If so, the per play fee could become the predominant basis for calculating license fees because (contrary to the experience in the interactive market) it might produce revenues higher than those that would be generated under the percentage of revenue or per subscriber fees.

Under these circumstances, it is possible that the music services might seek to negotiate a different per play rate in a free market. As I noted earlier, the per play fee and per subscriber fee protect the copyright owner in the event that the music service prices its services below market (*see* Section VI.B for a fuller discussion). In the non-interactive market, where many of the music services are non-subscription services, this protection must be supplied by the per play rate. [ ]

[redacted]

Accordingly, to predict the per play rate that would be negotiated if the adjusted [redacted] play proved unacceptable to music services, my starting point is the per subscriber minimum derived for the non-interactive market. In this scenario, the per play rate should be equal to the per subscriber rate divided by the number of plays.

Live 365 reports that the average "active" listener uses its service 32 hours per month,[19] and I have assumed even higher usage of 45 hours per month. This results in 697.5 plays per month at an average of 15.5 plays per hour -- substantially higher than the average number of plays per subscriber for the interactive music services. Interview by Eric J. Savitz with Rob Glaser, CEO, RealNetworks, Inc. (stating that the "average Rhapsody subscriber listens to over 200 songs a month"), in *Real Rivalry Comes to Online Music*, SmartMoney Magazine, June 15, 2005, available at http://www.smartmoney.com/mag/ceo/index.cfm?story=july2005&src=&nav=RSS20&pageid=display-in-the-news.module&pageregion=itn-body. [redacted]

Once again, I note that this is conservative. In my analysis I assumed that if -- because of the greater number of plays in the non-interactive market -- the record companies and music services negotiated a per play rate in a manner different than the way that rate was negotiated in the interactive market, the record companies would attempt to obtain the protection of a rate equivalent to the per subscriber rate. It is

[19] *See* http://www.streamingmedia.com/press/printversion.asp?id=2550.

possible, however, that the record companies would seek to obtain a rate that equaled the effective per play rate they obtain in the interactive market [[redacted]] adjusted in the manner discussed above to account for the lower value of a non-interactive service and the greater number of plays in the non-interactive market. [[redacted]]

F. Substitutability for or Promotion of Other Services

The question of whether DATs are net substitutes or complements for other sales of recorded music is raised explicitly in the statute governing this proceeding. Among the considerations that a willing seller would take into account in setting license fees in the marketplace is "whether use of the service may substitute for or may promote the sale of phonorecords or otherwise may interfere with or may enhance the sound recording copyright owner's streams of revenue from its sound recordings."[20]

In the discussion above I assumed that the copyright holder would maximize profits in each market (interactive and non-interactive) independent of the effects of the fee on any other markets where the copyright holder receives revenues. We must now consider the effect of relaxing this assumption. First, I will examine the issue of interdependence across the two DAT markets. Second, I will examine the effect of DAT markets on sales of CDs.

1. Substitutability for or Promotion of other Music Services

Consumers are presented with a wide array of competing music services in the marketplace. They will make their choices based on the characteristics and prices

[20] 17 U.S.C. § 114(f)(2)(B)

charged for the services. It is reasonable to expect that lowering the price of one type of service, e.g., a non-interactive service, will cause some customers to switch away from a substitute service, such as an interactive service. In technical terms the cross-elasticity of demand for these two services should be positive. This means the two services are substitutes for each other.

The implication of substitutability of these two services is that the current compulsory license for NI-DATs has constrained the copyright fees charged to the music services providing interactive DATs. Under the current compulsory license, the low copyright fee permits subscription-based non-interactive services to charge less than they otherwise would. This in turn pulls down the rate that can be charged for interactive services which, at least to some degree, will compete with the subscription-based non-interactive services. Referring back to Figure 1, this means that the demand curve for the interactive services has been shifted down by the artificially low compulsory license fee for non-interactive services. The absolute level of our benchmark copyright license fees therefore is artificially lower than it otherwise would be, and the absolute level of the fees recommended for the compulsory license is conservatively lower than it ought to be in a free market.

Moreover, as discussed above, if indeed there is a positive cross-elasticity between interactive and non-interactive DATs, the non-interactive DATs will cannibalize some of the higher margin interactive sales. That is, some consumers who otherwise would subscribe to an interactive service will subscribe instead to a non-interactive service, to the detriment of the record companies, which earn higher license fees from

interactive services. As a result, in a free market a copyright owner would increase the price demanded for non-interactive DATs.

I have not, however, sought to quantify either the negative effect that the non-interactive market has on prices in the interactive market, or the effect the non-interactive market has on diverting sales from the more lucrative (for the record companies) interactive market. Again, therefore, the estimates I am providing are conservative.

2. Substitutability for or Promotion of CD Sales

With respect to the interplay between Internet music services and sales of CDs, non-interactive DATs have been analogized to terrestrial radio, which has long been assumed to be complementary to CD sales (i.e., with promotional effects dominating). The simple reasoning is that listeners learn about new music on the radio and then buy the music on phonorecords. In other words, radio exposes listeners to new music, which some claim results in increased sales of new CDs.

There are many questionable assumptions in that claim, and there is scholarship that challenges it directly. The flaws in the argument are several. First, it ignores the impact of radio on the amount of time that consumers spend listening to recorded music.[21] Radio and recorded music compete for the listener's time, and the less time spent listening to CDs, the fewer CDs will be sold. This will have the effect of offsetting some, all, or even exceeding any possible promotional effects from exposure to new music. Moreover, it has also been pointed out that the increased exposure to music on radio does not necessarily have a positive impact on sales, and thus doesn't necessarily work to offset the substitution effect. The reason is that learning more about a product

[21] Stan J. Liebowitz, *The Elusive Symbiosis: The Impact of Radio on the Record Industry*, Review of Economic Research on Copyright Issues, 2004, vol. 1(1) pp. 93-118.

prior to purchase may make the consumer a better and wiser consumer, which may allow him to purchase fewer, but more desirable, CDs. In his attempt to test whether terrestrial radio is a net complement or substitute for record sales, Professor Liebowitz found that radio play does not benefit overall record sales.

Second, that radio play, combined with a wide variety of other focused promotion efforts, may help sell some sound recordings does not mean that, overall, radio play increases the sale of recorded music. Where, as here, we are dealing with a blanket license, the individual effects on particular songs which are in heavy rotation on over-the-air radio says nothing about the effect on all music -- which is likely to be purchased less when consumers have other listening options.

Third, as was true in the last webcaster proceeding, even if one were to assume that over-the-air radio overall increased record sales, it is an enormous unsupported leap to claim that webcasting is also promotional. The wide number of niche stations and the different experience of webcasting suggests that there are strong reasons to believe that non-interactive webcasting supplants rather than enhances CD purchases. I note that Wall Street analysts have recognized this effect in the context of satellite radio, finding that the future of the music industry is threatened by the many programming options offered by competitors such as XM and Sirius, that such services cannibalize record sales, and that the music industry's continued viability depends on getting fair market rates in proceedings such as this.[22]

Finally, one can simply look at the alternatives to see how webcasting likely affects other revenue streams for the record companies. Time spent listening to NI-DATs must be coming from one of several alternative uses of time: (1) listening to CDs; (2)

[22] SX Exhibit 210 DP at 35-40 (Citibank analyst report on Warner Music Group).

listening to interactive DATs; (3) listening to terrestrial radio; (4) other activities, e.g., watching TV. Of these four alternatives, only the fourth may lead to increased CD sales through the exposure effect. Substitution for time spent listening to CDs or interactive DATs will be costly to the copyright holder. Time spent listening to radio is unlikely to make much of a difference in terms of exposure to music if one were to assume a similar promotional effect between the two. Therefore, I would expect that increased listening to NI-DATs would not lead to an increase in CD sales.

In any event, the relevant empirical issue for the benchmark approach is not whether non-interactive DATs are substitutes or complements to CD sales. Rather, all that matters is whether non-interactive and interactive DATs affect CD sales differently. Where interactive music services are concerned, the question of whether such services are promotional or substitutional with respect to CD sales has already been answered by the market -- that is, when the parties negotiated a license fee, they presumably took into account the likely impact of that license on CD sales. If the impact of non-interactive services on CD sales is the same as the impact of interactive music services, no adjustment to the rates proposed above would be necessary, because that impact was already accounted for in the give and take between willing buyer and willing seller. If there is a *different* promotional or substitutional effect on CD sales in the non-interactive market, compared to our benchmark interactive market, an adjustment may be appropriate.

I have seen no evidence to suggest that there is any difference between these two markets with respect to their promotional or substitutional effects. One might argue that the on-demand characteristics of interactive DATs will lead to greater substitution for

recorded music than would be expected for non-interactive DATs. And one might argue, to the contrary, that non-interactive music services tend to substitute for CD sales to a greater degree than interactive services because subscribers to non-interactive services spend relatively more time listening to those services (thus reducing the amount of time available to listen to CDs). Although I have found no empirical support for either position, I have been asked to provide a sensitivity analysis to show the maximum possible effect on rates that would result if interactive services substituted for CD sales to a greater degree than non-interactive services.

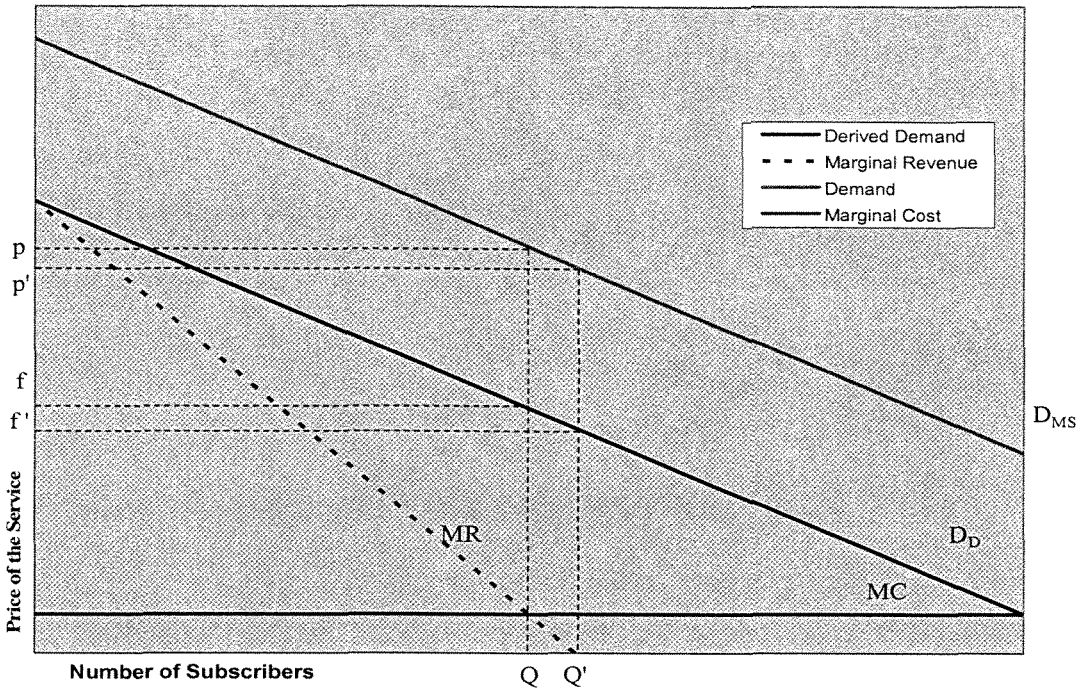
The model depicted in Figure 1 can be adjusted to take account of the possibility that interactive music services may substitute for CD sales to a greater degree than non-interactive music services. I will show this adjustment assuming that, for the average consumer, subscribing to an interactive DAT will decrease the consumer's purchases of CDs by two CDs per year. Further assuming that the margin on a CD is $5.60, this yields a loss of $11.20 in annual profit from the effect of interactive DAT subscription on CD sales.

The loss in CD sales can be treated analytically as an increase in the marginal cost of the copyright holder of providing (or licensing) interactive DAT services, i.e., each additional interactive music service subscriber will "cost" the copyright holder lost sales and profits from CDs. This increase in marginal cost will change the equilibrium conditions in the market. Prices will increase and total license fees (or profits to the copyright holder) will decrease. Using the neutral assumption of a linear demand curve, it is possible to show that prices will increase by 47¢/month/subscriber and the fee will increase by 47¢/month/subscriber.

The next step in our sensitivity analysis is to remove the effect of lost CD sales from the observed copyright fees charged for interactive DATs. This will allow us to estimate what benchmark fees would be charged, were it not for the assumed differential substitution effect. These adjusted benchmark fees will then be used to estimate the compulsory license fees for non-interactive DATs making the same adjustments as before for non-interactivity.

In order to quantify the effect of CD substitution on the benchmark rates, we must assign numerical values to the model. I have selected the average monthly retail rate of $8.29. As shown in Figure 2 below, we can adjust for the effect of CD substitution by observing that the optimal fee with substitution (the hypothesized current situation) would be obtained where marginal revenue equals the marginal cost, where marginal cost is now $.93 per subscriber per month reflecting the lost profits on CD sales. The equilibrium price and fee are labeled in Figure 2 as "p" and "f." [[redacted]]

Figure 2: Copyright Fees Given Lost Profits from Substitution Away from CDs



To remove the substitution effect, we now need to show what the copyright fee would have been if marginal cost were zero, instead of $.93 per month. Removal of the substitution effect will restore us to a situation where marginal cost to the copyright holder is zero. This will now yield a new equilibrium where the fee has declined by 47¢ per month and the retail price has fallen by 47¢ per month. As shown in Figure 2, the new fee f* will be [redacted] the new retail price p* will be $7.82. The ratio of the new per subscriber license fee to the old per subscriber license fee is 0.84 [redacted]

The percentage of revenue and per play components of the fee structure should be adjusted by the same ratio -- .84 -- to reflect the impact that the substitution of two CDs per year resulting from subscription to an interactive service might have on license fees.

The results of these adjustments, using the most conservative numbers from sections VI.C, D and E of this testimony, are shown in Table 6.3 below.

Table 6.3: Adjustment of License Fees for Effect on CD Sales

	Non-Interactive Unadjusted	Non-Interactive Adjusted
Copyright Fee as "Greater of" Formula		
Percent of Revenue	36%	30%
Dollar/Month	$1.63	$1.37
Per Play	0.234¢	0.197¢

G. Application of the Rates Derived from Subscription Services to Ad-Supported Services

To this point, I have focused on subscription services, finding that such services are the best benchmark to use for deriving the proper rate. These services demonstrate what consumers are willing to pay and, because of the existence of free, ad-supported services, are likely priced below what consumers would pay if there was not a free alternative. For that reason, using them again is a conservative assumption.

I believe that the basic rate structure discussed above should be applied to all music services -- subscription and non-subscription -- that use copyrighted music under the compulsory license. There are a number of reasons for this conclusion.

First, the best evidence from the marketplace of the value that consumers attach to a good or service is the price they are willing to pay for the service in the free market. Indirect measures, such as the advertising revenue collected by non-subscription services, are likely to underestimate the true value of the music in the marketplace.

Second, it is by no means the case that ad-supported webcasters are, or will remain, the poor cousins to subscription services. Revenues from advertising (or bundled services) are likely to increase over time as these business models develop in the market. For example, it was recently reported that Google's ability to achieve scale efficiencies with its growing online advertising network may allow it to introduce "free service" offerings that will challenge a number of traditional fee-based models. Google has made remarkable gains over the past year in increasing the revenue it generates each time it shows ads to consumers, and similar gains can be expected of music services. Indeed, the marketplace for Internet radio is populated by those who believe that ad-supported models ultimately will prove the better business model. I note that Yahoo! -- one of the largest and most sophisticated players in the market -- has said publicly that it believes that ad-supported models are likely to be the most profitable. Paul Maloney, *Yahoo! Launch's Goldberg Sees Ad-Supported Version as Future*, Radio & Internet Newsletter, Feb. 14, 2003, http://www.kurthanson.com/archive/news/021403/index.asp ("Yahoo! Music's Dave Goldberg says the future for his company's Internet radio business is with the ad-supported channels, and its listener-influence 'rating' systems.").

Third, even if, in the long run, ad-supported services prove less profitable than subscription services, that does not mean that a copyright fee should be set in order to accommodate the ad-supported model. In a free market, the owner of the intellectual property, e.g., the record companies, would set a fee based on the highest-valued use of its property, rather than sell at a lower price to an alternative delivery mechanism that would undermine sales of the higher-priced service option. Moreover, it is not practical to set different rates for different business models. The market is fluid and rapidly

evolving based on a number of different business models. There is no clear boundary between the subscription and non-subscription services. Rather, music services may earn revenue by combining subscriptions with advertising, as well as sales of other goods and services promoted by the website or portal offering the music service. In short, the record companies in a free market would set a rate targeted at the most profitable segment of the music service business. If this meant that inefficient or less-profitable businesses did not survive, that is not a bad outcome from the standpoint of economic efficiency, nor is it an indication that the compulsory fee has caused an outcome that is different from what happens in the free market. Rather, markets should be expected to yield an industry structure that supports only the most efficient firms.

Fourth, setting similar fees for subscription and non-subscription services simply preserves the status quo, where the same per stream rate applies to both business models (although subscription services currently have alternative calculations available to them). I see no compelling economic reason to change the status quo in this regard.

Fifth, although the majority of listeners use free non-interactive services, subscription services do make up a significant part of overall listening. Many people obtain non-interactive webcasting services bundled with other subscription services such as AOL. The fact that these services are bundled does not detract from the validity of using their unbundled prices to determine their value.

For all of these reasons, I believe that the rates I propose based on my analysis of subscription services should apply to both subscription and non-subscription services (with the exception of the per subscriber rate).

VII. Additional Information From Other Marketplace Agreements

A review of a number of other marketplace agreements, as well as publicly available data, suggest that the copyright fees derived above are within the range of reasonableness of what a willing buyer and willing seller would agree to in the marketplace. I discuss each of these in turn.

Licenses for Music Videos: Music videos are one of the only areas in which record companies are able to negotiate licenses that include both interactive and non-interactive streaming. These services are very similar to interactive and non-interactive DATs, except that they involve music videos, rather than simply music. They do provide, however, a useful benchmark for seeing what a willing buyer and willing seller would negotiate in the marketplace and how they would value interactive streaming relative to non-interactive streaming.

Although there are a variety of different agreements with different rate calculations, as described in the statements of Mark Eisenberg at 25; Lawrence Kenswil at 17-18; Stephen Bryan at 20-21; Ken Parks at 15, [ ][23]

These agreements show two things. [ ]

[23] Music video services are generally ad-supported, [.]

[redacted]

PRO Royalties: Also as discussed above, I do not believe that one can use the amounts paid for music publishing for non-interactive DATs as a benchmark for setting the copyright fee for sound recordings. The differences between the value that the market places on blanket licenses for sound recordings and music publishing licenses are simply too great.

Nonetheless, the *ratio* of the rate that music publishers are paid for interactive services vs. non-interactive services is somewhat more instructive. As a ratio, some of the effects of the different values that the market places on sound recordings and musical works drops out and we are left with more of a measure of the value of interactivity. On a percentage of revenue basis, the music publishers receive approximately 5.1% of revenue for non-interactive DAT services. As noted above, there is a dispute about the amount that music publishers will be paid for interactive services. *See* footnote 7. Nonetheless, the only agreement of which I am aware is consistent with a mid-point between the reported dispute between interactive services and music publishers -- approximately 10% of revenue.

[redacted]

Clip Sampling: Clip samples are the 30-second samples provided to users considering the purchase of a sound recording. They are highly promotional for record sales (they can only be used in situations where there is an express offer of a sound recording for sale), and they are in no way substitutional for CD sales or other sources of record industry revenue.

As described in the statements of Mark Eisenberg at 23-24; Lawrence Kenswil at 19-20; Stephen Bryan at 11-12; Ken Parks at 15-16,where a company makes a business off of clip sampling, purporting to promote sound recordings, record companies nonetheless are paid a percentage of revenue (sometimes in a greater of formulation with a per play floor). The percentage of revenue generally ranges from [redacted]. In my opinion, the percentage of revenue that record companies should receive for non-interactive DATs (in conjunction with a per play floor and a per subscriber minimum) cannot possibly be less than [redacted] No matter how promotional webcasters might claim their services to be, they could not be more promotional (and less substitutional) than clip samples.

VIII. MOBILE SERVICES SHOULD PAY A PREMIUM

Several new services have recently been offered or announced that provide streaming of music on cellular phones and other mobile devices. For example, Sprint now offers unlimited access to 20 commercial-free channels of SIRIUS Music on its multimedia handsets for $6.95 per month. This is a major evolution in how music

licensed under the compulsory license at issue in this proceeding is being used. As stated by the two partners involved in the Sprint/SIRIUS deal, "Sirius Music broadens Sprint's portfolio of music offerings and puts content from the biggest names in music right in the hands of millions of Sprint customers nationwide."[24]

These new mobile services appear to command a premium in the marketplace. As shown in the table below, all but one of the services is priced at or above $5.95 per month. By comparison, a substantial percentage of the non-mobile services are available at a lower price. Notwithstanding the higher price, the typical mobile service offers fewer channels than the non-mobile service, and the music is carried at lower bit rate.

Table 8.1 Subscription Mobile Phone Internet Radio Services

Service	Monthly Price	No. of Stations
Mobzilla	$ 3.98	30
Music Choice	$ 5.95	6
MSpot Radio	$ 5.95	13
MSpot Music Radio	$ 5.95	17
Sirius Sprint	$ 6.95	20
Rhapsody Radio	$ 6.95	100

I believe that the unique positioning in the marketplace of mobile music services means that the recommended license fees I derived in Section VI based on non-mobile services should be adjusted for mobile services. The previous comparison between consumers' valuation of interactive and non-interactive DATs only applies to stationary music services. To the extent that consumers attach a value to mobility, then appropriate comparison should be between *mobile* interactive services and *mobile* non-interactive services. Since there are no mobile interactive services (i.e., interactive services that can

[24] http://www.shareholder.com/sirius/ReleaseDetail.cfm?ReleaseID=172838&cat=&newsroom=

be accessed over a wireless network), and thus there is insufficient information to perform this valuation, I recommend instead that the fees derived in Section VI apply only to uses of the compulsory license for stationary services. I propose that services available to consumers over wireless networks that utilize the blanket compulsory license pay an adjustment above the stationary rate.

I would prefer to expand the hedonic regression to derive a measure of the added value of mobility; however, the data is not rich enough to provide meaningful hedonic measurements. Therefore I propose a premium based on two significant pieces of evidence from this nascent marketplace. First, the best apples-to-apples measurement of the value of mobility is the difference between the prices of the two Rhapsody radio services, which are virtually identical with the exception of mobility. The monthly price of the stationary Rhapsody Radio service is $4.99. The monthly price of the Rhapsody Mobile Radio Service is $6.95. The mobility premium is 39%.

A second basis for setting a premium license fee is to compare the median subscription rate on mobile Internet radio services ($5.95) to the median subscription rate on stationary Internet radio services ($4.99).[25] The mobile premium derived from the ratio of the two medians is 19%.

Because I presently have no further data, I can say only that a premium between 19% and 39% would be in the range of reasonableness, but market evidence is compelling that some premium for portability is appropriate.

[25] I reject comparing the mean of the subscription prices of the two types of services, because the mean price of the stationary services is skewed by a small number of observations in the tail of the distribution. These observations do not appear to be particularly relevant to a measurement of how much value consumers attach to mobility.

IX. CONCLUSION

The market for interactive music services provides a significant number of contracts, freely negotiated between willing buyers and willing sellers, that establish a compelling benchmark by which to set the rates for non-interactive digital audio transmissions in this proceeding. [ ] Further, adjusting those rates to account for the absence of interactivity and other relevant factors, I believe that the appropriate rates are the greater of 36% of revenue, $1.63 per subscriber, or 0.234¢ per play if the rates are not adjusted for any differential substitution effect, and 30% of revenue, $1.37 per subscriber, and 0.197¢ per play if a substitution adjustment is employed.

Appendix A

Data on Contract Terms and Retail Subscription Prices for DAT Music Services.

Table 1. Key Terms of Current Contracts Between Studios and Tethered Interactive DAT Music Services.[26]

[redacted]

[26] [redacted]

[27] This column identifies the date of the agreement that set the primary terms. Sometimes this was the date of the original agreement, other times it was the date of an amendment to the original agreement.

Table 2. Current Retail Prices for Tethered Subscription Interactive DATs

Service	Monthly Retail Price	Monthly Retail Price with Annual Contract
Y! Music Unlimited	$6.99	$4.99
Musicmatch On Demand	$6.99	$4.99
Rhapsody Unlimited	$9.99	$8.33
Napster Membership	$9.95	$9.95
MusicNow	$9.95	$9.95
AOL - MusicNet	$8.95	$8.95
Virgin Digital	$7.99	$7.99
Average	**$8.69**	**$7.88**

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

Michael D. Pelcovits

Michael D. Pelcovits

Date: 10-31-05

Exhibit Sponsored by Michael Pelcovits

210 DP	Citigroup research report on Warner Music Group (Sept. 22, 2005)

Before the
COPYRIGHT ROYALTY BOARD
LIBRARY OF CONGRESS
Washington, D.C.

In the matter of:	
The Digital Performance Right in Sound Recordings	Docket No.
and Ephemeral Recordings (Webcasting Rate Adjustment Proceeding)	2005-1 CRB DTRA

Volume 9

Room LM-414
Library of Congress
First and Independence Ave,, S.E.
Washington, D.C. 20540

Monday,
May 15, 2006

The above-entitled matter came on for hearing, pursuant to notice, at 9:30 a.m.

BEFORE:

THE HONORABLE JAMES SLEDGE, Chief Judge
THE HONORABLE WILLIAM J. ROBERTS, JR., Judge
THE HONORABLE STAN WISNIEWSKI, Judge

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I-N-D-E-X

WITNESS:	DIRECT	CROSS	REDIR	RECRO
Michael Pelcovits	6			
By Mr. Steinthal		104		

EXHIBIT	DESCRIPTION	MARK	REC'D
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1 P-R-O-C-E-E-D-I-N-G-S

2 (9:37 a.m.)

3 CHIEF JUDGE SLEDGE: We'll come to

4 order.

5 Mr. Handzo.

6 MR. HANDZO: Good morning, Your

7 Honor.

8 SoundExchange is going to resume

9 its case with Dr. Michael Pelcovits. We have

10 our usual notebooks.

11 Whereupon,

12 W. MICHAEL PELCOVITS

13 was called as a witness by counsel for

14 SoundExchange, and after having been first

15 duly sworn, was examined and testified as

16 follows:

17 DIRECT EXAMINATION BY COUNSEL FOR

18 SOUNDEXCHANGE

19 BY MR. HANDZO:

20 Q For the record, would you tell us

21 your name?

22 A Yes, my name is Michael Pelcovits.

1 Q Dr. Pelcovits, what is your
2 business or profession?
3 A I'm a consultant with the
4 consulting firm of Micra, microeconomic
5 consulting and research associates. I've been
6 with Micra for three years.
7 Q What is your educational
8 background?
9 A I received my bachelor's degree in
10 economics from the University of Rochester in
11 1972, and I attended MIT, Massachusetts
12 Institute of Technology where I received my
13 Ph.D. in economics in 1976.
14 Q Where are you currently employed?
15 A As I mentioned, I'm employed at
16 Micra consulting firm in Washington, D.C.
17 Q Can you just tell us a little bit
18 more about what the business is Micra is?
19 A Sure, Micra is a firm entirely of
20 economists. We work in a variety of applied
21 microeconomic fields. We are engaged in
22 analyzing industries, rate setting, costing

1 issues, a whole variety of applying
2 microeconomics to different primarily
3 litigated cases, in the anti-trust, in the
4 regulatory arena, and then quite a lot of
5 other forms as well.
6 Q Dr. Pelcovits, how long have you
7 been with Micra?
8 A Three and a half years.
9 Q Prior to joining Micro where were
10 you employed?
11 A I was employed for 14 years at
12 MIC, which at one point was acquired by
13 WorldCom. I like to remember it as MCI. I
14 was employed there for that entire position.
15 Q What was your position with MCI?
16 A I started out as a senior staff
17 economist, and I moved up through the ranks
18 and eventually became the chief economist and
19 a vice president.
20 Q Did any of your work at MCI
21 involved rate-setting proceedings?
22 A Quite a lot. Rate setting is

1 essential, a key part of telecommunications
2 industries. Rates are set for a variety of
3 telecommunication services by state regulatory
4 commissions, by the FCC, and in foreign
5 countries by their respective regulatory
6 bodies.
7 And it was essential to MCI's
8 business to be involved very heavily in how
9 those rates were set, either for itself and
10 also quite extensively as an intervenor in
11 those cases.
12 Q Can you give us an example of a
13 rate-setting proceeding with MCI?
14 A Sure, I think probably among the
15 most significant and monumental efforts that
16 the entire industry was engaged in for many
17 years was the setting of rates and terms under
18 which competitors in the local telephone
19 markets were able to interconnect and use the
20 networks of the incumbents.
21 This was an issue that was a
22 consequence of the 1996 Telecommunications

1 Act, which permitted entry into the local
2 telephone market.
3 And as a result for several years
4 I was really in charge of MCI's efforts at
5 being involved at the FCC and in the states at
6 trying to get the methodologies and the rates
7 that would be favorable to the business.
8 Q Did your work at MCI involve any
9 work on Internet issues?
10 A Yes, they did.
11 Q Can you describe that for us?
12 A Sure. The Internet was a very
13 major part of MCI's business. MCI was a
14 leader, in fact the first major provider of
15 the Internet backbone, and always remained the
16 largest Internet backbone in the country.
17 MCI dealt, and I had to deal,
18 working with MCI colleagues, with economic
19 issues relating to the Internet as they
20 pertained to a number of issues that were
21 brought up in the context of either merger
22 approvals, in the context of reviewing of the

1 policies dealing with peering, Internet
2 networks.
3 So I would say that it was a
4 substantial part of my attention, particularly
5 the last several years at MCI.
6 Q Did those issues involve broadband
7 access as well?
8 A There were issues also relating to
9 broadband access to the Internet. It was
10 almost a separate class of issues, because at
11 the same time that we were trying to foster
12 competition in the local telephone market in
13 terms of the regular, pick up the phone and
14 dial a phone and make a call, it was also the
15 time when competition was blossoming, and
16 there were quite a lot of developments in the
17 broadband access to the home by cable modems
18 and also, and an area that was very important
19 to MCI, through the DSL products that were
20 being introduced by both the Bell companies
21 and also several competitors, including MCI.
22 And there was quite a lot of

1 issues involved in terms of access, pricing,
2 regulation of the broadband access to the
3 home.
4 Q What were the pricing issues for
5 broadband?
6 A Well, there were pricing issues in
7 terms of access to the underlying network
8 element that was needed by a competitor to
9 compete in the market. There were issues
10 relating to whether broadband prices and
11 access would itself be regulated by the FCC.
12 And there was a lot of issues
13 dealing with to what extent would broadband or
14 for example voice-over-Internet protocol used
15 over broadband would become a substitute for
16 conventional telephone service.
17 Q Have you written at all on the
18 subject of the Internet?
19 A I have. I was asked to write a
20 chapter of a book on the economics of the
21 Internet. I co-authored with Dr. Vincent
22 Cerf, who is indeed one of the fathers of the

1 Internet.

2 Q Prior to your employment with MCI,

3 Dr. Pelcovits, where were you employed?

4 A I had a number of different

5 employments. I worked for about seven years

6 in a consulting firm that I co-founded. The

7 name of the consulting, Cornell, Pelcovits and

8 Brenner. We were also refugees from the FCC,

9 and we consulted on quite a lot of

10 telecommunications and other applied economic

11 issues in a number of other industries.

12 Q Can you give us an example?

13 A Well, I did a lot of work

14 testifying on rate-settingi issues. Primarily

15 at that time they involved in terms of access

16 to the network by long-distance companies, and

17 the pricing of access in the state regulatory

18 commissions.

19 We also worked on one of our first

20 cases that sort of got us started as a firm.

21 We worked for Sony following the famous

22 Betamax case at the Supreme Court where there

1 was pending and proposed legislation to impose
2 various taxes on video recording, and we
3 worked for Sony to develop some of their
4 material for Capitol Hill on those issues.
5 Q And just quickly, prior to
6 Cornell, Pelcovits and Brenner, where did you
7 work?
8 A I worked at the place where I was
9 eventually a refugee from, the FCC. I was on
10 the office ¦ I was in what was called the
11 Office of Plans and Policy. It was really
12 where the economists were housed along with
13 some engineers.
14 I worked for a year at the Civil
15 Aeronautics Board, and for a couple of years
16 after graduate school I was an assistant
17 professor at the University of Maryland,
18 College Park.
19 Q Professor of economics?
20 A Yes, in the economics department.
21 Q Dr. Pelcovits, have you testified
22 as an expert in microeconmic issues before?

1 A I have. I've lost count, but I've
2 testified I'd say probably 40 times in state
3 regulatory proceedings on rate setting and
4 other economic and policy types of issues.
5 Q That may have anticipated my next
6 question, but how many of those times that you
7 testified involved rate-setting proceedings?
8 A I would say at least half,
9 probably more. There are a lot of issues
10 relating to costing, pricing, that have sort
11 of been at the key of the industry for the
12 entire time that I've been active, I'd say
13 since I was at the FCC in 1979, from then on.
14 MR. HANDZO: I would offer Dr.
15 Pelcovits as an expert in applied
16 microeconomics.
17 CHIEF JUDGE SLEDGE: Any objection
18 to the offer?
19 MR. STEINTHAL: Your Honor, if we
20 can reserve for voir dire on cross.
21 MR. JOSEPH: Likewise, Your Honor.
22 CHIEF JUDGE SLEDGE: Without

1 objection, the offer is accepted.
2 BY MR. HANDZO:
3 Q Dr. Pelcovits, when were you
4 retained by SoundExchange in this case?
5 A I was retained in August of last
6 year.
7 Q What were you asked to do for
8 them?
9 A I was asked to essentially analyze
10 the issues relating to setting a rate for use
11 of sound recordings according to the statute
12 for noninteractive webcasts.
13 I was asked to develop a
14 recommended rate and present the economic
15 reasoning and analysis in a testimony.
16 Q Can you give us an overview of
17 what you did when you first began this
18 engagement?
19 A I think the starting point for me
20 was really reading the previous CARP decision
21 and to get a good understanding of the legal
22 framework behind the case. Primarily I would

1 say I didn't try to play lawyer, I read the
2 CARP decision and read filings from the
3 previous decision ¦ from the previous
4 proceeding. I read significant amounts about
5 the industry and also about some of the
6 economic issues that had been researched and
7 written in the literature about the industry.
8 And I discussed with the attorneys
9 at Jenner & Block about obtaining certain
10 types of information, particularly information
11 on the contracts that had been entered into
12 between the webcasters and the record
13 companies for what I felt would be a good
14 benchmark service.
15 I would say ¦ add one other thing
16 to the list, which is, I also got quite
17 familiar with the nature of the services that
18 were being provided by the webcasters, a
19 combination of having research assistants try
20 to dig up and collect as much information as
21 they could, and even as mundane a task as
22 trying a lot of them out myself.

1 Q Based on your review of the CARP
2 decision, what did you understand the legal
3 standard that you were going to be applying
4 here to be?
5 A The legal standard is referred to
6 as the willing buyer-willing seller standard.
7 Q And what did you understand the
8 hypothetical market for our willing buyers and
9 willing sellers to be?
10 A Well, the market, or the
11 hypothetical market would be for the licensing
12 of the copyrighted works of the copyright
13 holders to whatever broadcaster would observe
14 the statutory requirements, primarily no
15 webcasting, but essentially any use that
16 follow the constraints in the statute.
17 Q And just to be clear, who did you
18 understanding the willing sellers in this
19 market to be?
20 A The willing sellers are those that
21 own the copyrights, which is principally the
22 record companies.

1 Q And who did you understand the
2 willing buyers to be?
3 A Willing buyers are whoever is in
4 the market and wishes to obtain a license in
5 order to provide a noninteractive webcast.
6 Q And finally, what did you
7 understand the willing sellers to be selling
8 to the willing buyers?
9 A I understood them to be selling a
10 blanket license for all of the copyrighted
11 music that they had the copyright to.
12 Q What approach did you adopt, Dr.
13 Pelcovits, to come up with a rate proposal in
14 this case?
15 A The approach I adopted is termed a
16 benchmark approach. And benchmark approach
17 simple means looking for evidence from
18 comparable markets, and examining that
19 evidence to try to get a sense of what willing
20 buyers and willing sellers are doing in the
21 marketplace.
22 Q What are the advantages of using a

1 benchmark approach?
2 A Well, the advantages, I would say
3 fundamentally, first of all you're dealing
4 with evidence that is there in the market.
5 There is actual data. The first thing an
6 economist looks for is data. So you have data
7 in the market. You have the advantage of
8 actually seeing the result of the marketplace
9 forces from both the demand side and the
10 supply side. So you're seeing market
11 equilibria, and you are able to observe the
12 outcome of all the different forces that are
13 influencing the buyers and the sellers.
14 Q In your view, Dr. Pelcovits, what
15 are the characteristics of a good benchmark?
16 A Well, the characteristics of a
17 good benchmark are, obviously it has to be a
18 reasonably similar market with similar
19 characteristics, and in this case I would say
20 in general, you don't always have this
21 opportunity, you have the same buyers and the
22 same sellers.

1 You have in the same copyrighted
2 works being provided, and you have the
3 copyrighted material being used in a manner
4 that it's provided to customers in a very
5 similar way.
6 Q You have described the
7 similarities of your benchmark, but I guess we
8 should first identify what market you chose as
9 your benchmark.
10 What market did you choose as the
11 benchmark?
12 A The market I chose was the market
13 for interactive or alternatively let's call it
14 on-demand webcasts.
15 If I could give an example, it
16 would simply be a service where a customer
17 subscribes, pays a monthly fee, for example,
18 to Rhapsody, and is able to listen to
19 relatively high quality streaming audio of his
20 or her own selection by choosing artists, by
21 choosing albums, by choosing songs.
22 Q I think you've already touched on

1 it, but what were the similarities you
2 perceived between the benchmark market ¦ and
3 if we can refer to the market that we're a
4 rate for here as the target market, does that
5 make sense?
6 A To have a common terminology,
7 right.
8 Q So the question was, what were the
9 similarities that you perceived between the
10 benchmark market and this target market?
11 A The similarities I'd say start
12 with similar buyers and similar sellers, and
13 by its very nature, then, very similar
14 products being exchanged between the buyer and
15 the seller, the same music, the same ability
16 to use the music for commercial purposes of
17 various sorts.
18 And then also the ability to look
19 at how that service, that music, is then as an
20 input used in the downstream markets by
21 consumers in various ways.
22 So that makes a good benchmark.

1 It has another attribute which I think is
2 really ¦ well, there are a couple of other
3 attributes.
4 One is, and this is very
5 important, they are similar, but they are I
6 believe sufficiently different that the
7 current rate set by the CART in the
8 noneconomic market does not have an
9 overwhelming influence on the rate in the
10 benchmark market.
11 In other words if the benchmark
12 were too close to the target market, you could
13 not use that information because the benchmark
14 would be strong affected by the gravitational
15 pull of the preexisting rate in the target
16 market which was not set by the market, but
17 set by the CART.
18 So it has to be sufficiently
19 different, and the other thing is that it has
20 to be amenable to analysis, to be able to look
21 at the difference between the characteristics
22 of the target and of the benchmark market and

1 measuring the importance of that
2 characteristic, and adjusting the rates in the
3 benchmark market for those characteristics in
4 order to come up with the recommended rate for
5 the target market.
6 Q Now in terms of your ability to
7 make adjustments, does that depend in part on
8 having sufficient data about the benchmark
9 market?
10 A It does.
11 Q And did you have sufficient data
12 about the benchmark market in your view?
13 A Yes, I would say I need data not
14 just for adjustments, but for just simply pure
15 analysis purposes, it's pretty hard to try to
16 apply, let's say, one or two pieces of data,
17 so the fact that there were a significant
18 number of contracts for the interactive
19 services, and the contracts were pretty
20 straightforward to see what the prices were.
21 Sometimes if you're doing an
22 analysis of certain markets, prices are not so

1 apparent. There's a lot of dimensions to
2 price, so it's important to be able to zero in
3 and identify the price that you're looking
4 for, so it had that characteristic.
5 And I've probably not answered
6 your question entirely.
7 Q That's fine.
8 Do you recall how many contracts
9 for the interactive market you saw?
10 A I recall that for the interactive
11 market I saw, I believe it was 29 contracts.
12 Q Where did you get those from?
13 A I got them from counsel, from
14 Jenner & Block.
15 Q In your analysis of the benchmark
16 market, did you exclude any of those contracts
17 from consideration?
18 A I won't say I excluded them from
19 consideration, but I eventually sort of zeroed
20 in on 17 of those contracts. There were
21 several cases where contracts, earlier
22 contracts, were superseded by later contracts,

1 so in that case I looked, and I used for
2 analytical purposes the more up to date
3 contracts.
4 And there was one other contract
5 that I excluded from the actual measurements
6 that I conducted, which was a contract that
7 essentially was a real outlier, used a
8 mechanism for calculating the payment that was
9 totally different than any of the other
10 contracts. It was called a slotting
11 allowance, and essentially when something is
12 so far off the general pool of data you have
13 it's conventional to take it out of the data
14 set and work with the data set you have.
15 Q So I'm sorry, in the end you would
16 up with 17 contracts?
17 A I ended up analyzinig and working
18 with 17.
19 Q Okay.
20 Let me ask you first of all about
21 the rate structure of the contracts in the
22 internactive markets.

1 What did you find with respect to
2 that rate structure?
3 A I found that almost all the
4 contracts had a three-part rater of structure.
5 Namely, the rate or the possible rate was
6 calculated three different ways, and the
7 amount paid by the webcaster was the greater
8 ¦ it's called greater, it really should be
9 greatest ¦ the greatest of the three different
10 rate calculations.
11 The three calculations were first,
12 a per play rate, which is ¦ am I allowed to
13 give the number here? Are we giving numbers?
14 Q Let's hold off on the numbers.
15 We'll get to that later.
16 A Well, there was a per play rate,
17 where a per play rate means a rate per every
18 time a song is played to a individual
19 listener. So if I'm sitting at home, and I
20 click, and I'm on Rhapsody, and I want to
21 listen to a particular song, and that song
22 plays, there is a ¦ essentially the meter goes

1 by one click.

2 The second was a per subscriber

3 fee. It's called a pro rate per subscriber

4 fee where the fee would be essentially based

5 on the number of subscribers to the service.

6 So if there are a million subscribers, and the

7 fee is ten dollars, the base of the fee is ten

8 million dollars.

9 Now that fee is then paid to the

10 individual record label according to its

11 contract, and the fee is based on the pro rata

12 share of plays on the webcaster that are using

13 the copyrighted material of that record label.

14 So if you are BMG Music and 25

15 percent of the plays on Rhapsody are of your

16 music, then you multiply 25 percent times that

17 $10 million I just gave, and that's the second

18 element.

19 The third element is a percentage

20 of revenue, which we've talked about is in the

21 range of about 40 to 50 percent, and once

22 again that is of ¦ there are a variety of

1 different definitions and adjustments taken,
2 but it's essentially the revenue that the
3 webcaster collects directly or indirectly from
4 the service, and again, the pro rata mechanism
5 is used to determine the amount due to the
6 particular record label under its contract.
7 Q Going back to the per subscribed
8 rate, is that set as an amount per subscriber
9 per month?
10 A Correct, it is per subscriber per
11 month.
12 Q Do you have an understanding, Dr.
13 Pelcovits, of what that rate structure exists
14 in this market?
15 A Yes.
16 MR. STEINTHAL: Objection, Your
17 Honor, lack of foundation.
18 CHIEF JUDGE SLEDGE: Repeat your
19 question.
20 MR. HANDZO: The question was
21 whether Dr. Pelcovits has an understanding of
22 what that rate structure exists.

1 CHIEF JUDGE SLEDGE: Overruled
2 WITNESS: I do. I have an
3 understanding that there are various
4 mechanisms to try to garner a share of
5 revenues, depending on how the music is used.
6 They're obviously working within a
7 context of uncertainty. If everyone knew
8 exactly what was going to happen when you
9 signed the contract, you wouldn't need a
10 greater than type of structure, because you
11 could essentially predict ahead of time which
12 was going to be the one that would essentially
13 be the greatest, and negotiate on that one, or
14 just negotiate on whatever you needed to if
15 you had perfect information.
16 So given that there is imperfect
17 information there, and sort of a ¦ there are
18 a lot of dynamic changes in the market, there
19 is concern by the record companies to be able
20 to collect revenue based on how the music is
21 used in the different services.
22 If it's played a lot more than

1 might have been expected, the per play rate
2 might come into force. If revenue is let's
3 say collected through a bundled service where
4 it's hard to attribute revenue for a
5 particular music service, because it's bundled
6 along with other things, the per subscriber
7 amount might become the key one.
8 If you're using the music and not
9 collecting a lot of music ¦ sorry, a lot of
10 money from the subscriber, but rather from
11 advertisers or other ancillary services, then
12 the revenue percentage might come into play.
13 Q Based on your review of the
14 contracts for the interactive market, did you
15 reach any conclusion about what the rate
16 structure should be for this case, for the
17 target market?
18 A I recommend that the same rate
19 structure apply. Once again we're dealing
20 with trying to look at the market and see what
21 willing buyers and willing sellers do.
22 Willing buyers and willing sellers

1 agreed on a three-part rate structure. It was
2 their way, quite frankly, of handling the
3 uncertainty of what was going on in the
4 market, and there is, within any negotiation,
5 a give and take. And this resulted in the
6 three-part rate structure, in the benchmark
7 market, and I believe that it's very important
8 to import that same rate structure into our
9 target market in order to take sort of account
10 of all those different factors that were
11 important in the other market, and also to
12 sort of capture what's behind the incentives
13 of the willing buyer and the willing seller.
14 Q Now in your report, Dr. Pelcovits,
15 in the end you recommend a set of rates.
16 Would there be any adjustments that should be
17 made to those rates if we did not use this
18 three-part structure?
19 A Yes, I believe that if you were to
20 sort of take my approach and import the rate
21 level from one of the pieces of this structure
22 but not the entire structure, you would be

1 sort of undervaluing the use of the music in
2 the target markets.
3 And the reason is that when you're
4 setting up a three-part structure, you are
5 getting something out of each one of them.
6 And if you say I'm not going to ¦ or I as the
7 seller am not going to get the benefit of two
8 parts of the rate structure, whatever those
9 benefits are, but obviously they're benefits
10 that affected their negotiations in the
11 benchmark market, if I'm going to give up some
12 benefits, then I can't simply take the rate
13 derived from the three-part structure without
14 making some adjustments to offset those lost
15 benefits of the rate structure itself.
16 MR. HANDZO: If I can just take a
17 break here for a second, I'm about to get into
18 restricted information with Dr. Pelcovits, and
19 restricted information involves the particular
20 prices that have been negotiated in the
21 benchmark market, and that is competitively
22 sensitive information. The record companies

1 don't share it with each other, certainly not
2 with the parties they're negotiating with.
3 So at this point I would request
4 that the court put us into executive session,
5 and designate this as restricted.
6 I actually don't see anyone in the
7 courtroom who would have to leave.
8 CHIEF JUDGE SLEDGE: This is to
9 review the rates that are part of contracts
10 that were in his benchmark?
11 MR. HANDZO: That's correct.
12 CHIEF JUDGE SLEDGE: Any objection
13 to the motion to apply the protective order on
14 questions and answers relating to the rates of
15 contracts used in the benchmark?
16 No objection. The motion is
17 granted.
18 MR. HANDZO: Thank you.
19 (Whereupon at 10:10 a.m. the
20 hearing in the above-entitled matter went into
21 closed session.)
22

1 CHIEF JUDGE SLEDGE: We are ahead
2 of our normal recess. Does anyone want to
3 start on cross-examination with this time
4 frame?
5 MR. STEINTHAL: I will start, Your
6 Honor.
7 CROSS-EXAMINATION BY COUNSEL FOR DIGITAL
8 MEDIA, ET AL.
9 BY MR. STEINTHAL:
10 Q Good morning, Dr. Pelcovits.
11 A Good morning, Mr. Steinthal,
12 correct?
13 Q My name is Ken Steinthal. We
14 haven't met.
15 A Yes, your reputation precedes you.
16 Q As does yours.
17 A Thank you.
18 Q Dr. Pelcovits, it's correct, is it
19 not, that prior to this engagement you had no
20 experience in the online music industry?
21 A As an economist no.
22 Q Other than your own use as a

1 consumer of online music, it's fair to say you
2 had no prior experience in the online music
3 industry?
4 A That's correct.
5 Q And that includes the webcasting
6 industry, does it not?
7 A That is correct.
8 Q What about the sound recording
9 business more generally? You had no prior
10 experience before this engagement in the sound
11 recording industry; correct?
12 A That's correct.
13 Q Indeed in connection with looking
14 at copyrighted content more generally, other
15 than dealing with software issues in
16 connection with telecommunication switches at
17 MCI, you had no experience dealing with
18 copyrighted content prior to this engagement,
19 correct?
20 A I mentioned also I had worked on
21 the Betamax issues, so that was the other
22 involvement I had in those issues.

1 Q Other than that limited Betamax
2 issue you testified about, you had no
3 experience dealing with evaluation of
4 copyrighted content other than software in
5 connection with telecommunication switches;
6 correct?
7 A And as you correctly mentioned,
8 that is an area in which I was involved, the
9 valuation of the copyrights contained within
10 telecommunications equipment, what are called
11 right-to-use fees, in that part of the
12 industry.
13 Q But in connection with valuation
14 of music or audio-visual copyrighted content,
15 you have no prior experience before this
16 current?
17 A As I mentioned, the Betamax
18 experience, but other than that, no.
19 Q The Betamax experience didn't get
20 you involved in evaluating or assessing the
21 value of music, did it, in any respect?
22 A It was not music; it was video.

1 That's correct.
2 Q Now it's also correct is it not
3 that you never interviewed or spoke with
4 anyone in the webcasting industry before
5 submitting your written report?
6 A That's correct.
7 Q And by definition then you talked
8 to nobody involved in webcasting under a
9 statutory license before submitting your
10 report; correct?
11 A That's correct.
12 Q And no one involved in the
13 delivery of on-demand streaming services, your
14 target ¦ I'm sorry, your benchmark market,
15 correct?
16 A That's correct.
17 Q Let me ask you some questions
18 about the research you did before writing your
19 written report.
20 Now I believe you said this
21 morning and in your written statement that you
22 reviewed material about the industry; correct?

1 A Yes.
2 Q Meaning the music industry
3 generally and the webcasting industry
4 generally?
5 A I guess as opposed to what? I
6 reviewed quite a lot of things about the music
7 industry, about copyright valuation, about
8 webcasting. So quite a big research project.
9 Q Well, putting aside the contract
10 you reviewed between individual labels and
11 licensees in the target and benchmark markets,
12 what specifically did you review?
13 A I reviewed and approached this
14 just like I would any other economic analysis
15 where I read as much as I can about the
16 industry, about the nature of the services,
17 about the market structure, the prices,
18 consumption patterns, relevant legal
19 decisions, and quite a lot of economics
20 literature that deals with both retail pricing
21 and valuation of intellectual property.
22 Q And that was all done by reading

1 materials that were publicly available to you?
2 A That's correct.
3 Q And all the materials you reviewed
4 you've identified in your report, correct?
5 A Well, the report doesn't liste
6 every single thing I reviewed. I obviously
7 talked in general about what I reviewed. I
8 think we provided material on discovery.
9 Q But apart from that publicly
10 available material that you reviewed, it's
11 correct, is it not, that you reviewed no data
12 about the webcasting business?
13 A I reviewed whatever data was
14 available in public sources.
15 Q You got no data from any
16 webcasters, correct?
17 A That is correct.
18 Q And the data from public sources,
19 can you tell me what specific kinds of data
20 you rely on in your report from public sources
21 about webcasting?
22 A I would have to go back and look.

1 I think there is a lot about webcasting that
2 is written in publications about the industry,
3 whether it's recent books, articles, annual
4 reports of the webcasters themselves, Security
5 & Exchange Commission reports of various
6 webcasters; their websites themselves where
7 they are describing at length their services
8 where they are trying to attract customers or
9 even attract users of their service.
10 So that's ¦ that is what I did.
11 Q So all your information about why
12 webcasters price certain services one way or
13 another way was derived for example from
14 websites or other publicly available
15 information; correct?
16 A I told you I didn't go into an
17 analysis of the whys; I looked at the market
18 evidence. So that in my mind is the hard
19 data that's available as opposed to what I
20 would think would be far less informative,
21 which would be to try to get some
22 impressionistic idea of why they are pricing

1 where they are.
2 Q But for example, when you do your
3 charts that are in you8r report, we'll come
4 back to that, you look at prices that are
5 listed for various products without any data
6 whatsoever about how many people are actually
7 paying those prices; right?
8 A From the public sources
9 themselves, I've seen data since then, but
10 from the public sources themselves, there is
11 limited data on the number of customers, and
12 it's also difficult to get the breakdown of
13 customers by the type of service they
14 subscribe to.
15 These are in the market. They're
16 actively promoted and sold. There was some I
17 believe it was AccuStream that had some data.
18 But in terms of the actual number of
19 subscribers on each service, that was not
20 publicly available; correct.
21 Q And I gather the information that
22 you just mentioned that you relied upon for

1 webcasters was the same whether it be
2 statutory licensed webcasters or on-demand
3 streaming and conditional download services?
4 A The services might be different
5 depending whether the companies were
6 different, but the types of research material
7 was similar.
8 Q Now, in addition to your review of
9 these materials, before you did your written
10 report you had two or three conference calls
11 with people in the sound recording industry,
12 correct?
13 A Yes.
14 Q And that was in the early stages
15 of your research, was it not?
16 A Yes, it was.
17 Q And do you remember who those
18 people were?
19 A I do not.
20 Q And the subject was largely about
21 the hold back issue, is that right?
22 A That was the primary reason for

1 the calls. I was trying to make sure I
2 understood the contracts, and I was
3 interpreting evidence properly. I was also
4 hoping to try to quantify the effects of the
5 hold backs, which can affect the value of the
6 music in the interactive contracts.
7 So that was really an area that I
8 was trying to see whether there was data or
9 other ways of making an adjustment in the
10 model for the hold backs, and that was the
11 nature of the research at that time.
12 Q But just so I understand it then,
13 you generated this report based on two or
14 three conference calls of that nature with
15 people you can't remember, and your review of
16 a series of contracts that you got from the
17 label representatives, or actually from
18 Jenner, and from the publicly available
19 information you gleaned about the industry;
20 correct?
21 A That's correct, I approached it
22 the way I would approach research that I've

1 undertaken in the past in other industries,
2 and the ¦ certainly a lot of effort into
3 getting a lot of material from the public
4 sources.
5 Q So you would agree with me that if
6 you had the same universe of data to tackle a
7 telecommunications problem before you
8 undertook this assignment, you'd have a heck
9 of a lot more experience and expertise to draw
10 on to reach conclusions about the project than
11 you did in taking on a subject like webcasting
12 in which you had no prior experience; isn't
13 that right?
14 A It depends a lot on what the
15 project was. There are projects I've done in
16 telecommunications, particularly newer markets
17 in telecommunications, where the ¦ you're
18 dealing with something which from an
19 analytical standpoint is very much sort of a
20 fresh look. That might be true of many things
21 related to the Internet. It would be true of
22 things related to, let's say, voice over IP;

1 I've done research and looked at that issue,
2 and wasn't a lot to discuss. It was trying to
3 understand the quantitative nature of things
4 going on, the prices, and the effect of price
5 bundling and other topics.
6 So it depends. It depends on the
7 project as to what is the appropriate research
8 step and tools to use.
9 Q Now you said you reviewed
10 contracts that were entered into between music
11 services and the copyright holders; correct?
12 A That's correct.
13 Q Those copyright holders were the
14 major labels; correct?
15 A That's correct.
16 Q Meaning the big four, are you
17 familiar now that there are four major record
18 companies?
19 A Very familiar.
20 Q And you didn't review any
21 contracts between other copyright holders and
22 music services, did you?

1 A I did not.
2 Q You know that SoundExchange
3 represents a great multitude of copyright
4 owners other than the majors?
5 A I do ¦ I am aware of that.
6 Q Did you seek any information about
7 contracts between other copyright holders than
8 the major four record companies from Jenner &
9 Block or the SoundExchange representative?
10 A I ¦ for the interactive web
11 servers you're talking here, because those
12 would be where you get the contracts, but I
13 did inquire as to whether I could get them in
14 time to do my analysis, and they were not
15 available to me.
16 Q You said it was for the
17 interactive services in your last answer.
18 A Right.
19 Q Are you familiar with the fact
20 that there were contracts entered into by both
21 major record labels and independent record
22 labels with certain webcasters?

1 A I did in fact address in my
2 testimony the contracts for the wider range of
3 webcasting services which use the term,
4 customized radio, to refer to those who can
5 add certain features that either are, or
6 arguably are, make them ineligible for the
7 statutory license.
8 CHIEF JUDGE SLEDGE: Judge
9 Wisniewski has just reminded me that Mr.
10 Handzo never concluded his portion of
11 questioning that was subject to the protective
12 order.
13 We are no removed from application
14 of the protective order.
15 MR. STEINTHAL: From the beginning
16 of my cross, yes, Your Honor, absolutely.
17 BY MR. STEINTHAL:
18 Q So basically in terms of the
19 contracts you reviewed, you reviewed what
20 Jenner & Block gave you and nothing else;
21 correct?
22 A That's correct.

1 Q By the way was the benchmark on
2 demand service market that you chose to rely
3 on something that you yourself thought of, or
4 was it suggested to you by someone else?
5 A I frankly don't recall. I know
6 early in the engagement I was presented, or
7 discussed, a number of different options. And
8 certainly interactive was raised, as were some
9 of the others that I mentioned in my
10 testimony.
11 So I did consider a number of
12 other benchmarks. And I will say that very
13 early on, it was my judgment, which I stand by
14 to this day, that those are by far the best
15 evidence in the market to serve as a
16 benchmark. It's very compelling, very
17 powerful, very useful evidence.
18 Q Sir, you would agree, would you
19 not, that a service seeking to offer
20 subscribers on demand access to specific music
21 recordings effectively must have a license
22 from each of the big four major record

1 companies; correct?
2 A Effectively it turns out to be
3 that way in the market. I don't know whether
4 it would be possible to have a more limited
5 tailored music service.
6 Q Well, we're talking about on
7 demand streaming conditional download services
8 that form your benchmark market, all of those
9 services tell consumers that they're offering
10 essentially the world's music on demand, don't
11 they?
12 A I don't know if I'd put it that
13 way. As I said, some of the ¦ particularly
14 the larger ones are advertising that they are
15 offering a wide range of music. They mostly
16 make that point by genre. They say, we have
17 a variety of different types of music that
18 we're offering.
19 They obviously can't represent
20 they have everything, because they don't have
21 everything.
22 Q Let's talk about that for a

1 second. You had mentioned that there are
2 times when certain tracks aren't available.
3 Is it your testimony, sir, that
4 the reason those tracks aren't available is
5 because of hold back rights associated with
6 the labels, and only that issue?
7 A As far as I'm aware, they are held
8 back or one way or another not released or
9 provided by the copyright holder, and that if
10 the music service wanted to ¦ obviously if the
11 music service wants to use a piece of music,
12 it has to get the approval of the copyright
13 holder.
14 Q And that copyright holder is more
15 than the sound recording owner, right?
16 A It can, yes.
17 Q The publisher as well?
18 A It appears the publisher as well.
19 Q And as a matter of fact, sir, are
20 you familiar with the fact that there are many
21 tracks that the services that are in your
22 benchmark market have the sound recording

1 rights to but have been unable to clear the
2 publishing rights to?
3 A I don't recall if I was aware of
4 that, but I can see that that would be
5 possible, and that would reduce the value of
6 those services to the consumers and ultimately
7 the value and how much they'd be willing to
8 pay to the sound recording companies for the
9 right to use their sound recordings. It
10 doesn't pay to get the sound recording if you
11 can't get the musical work with it. So it
12 doesn't matter why you can't get it; it
13 affects how much you're going to pay for it.
14 Q Well, you did your analysis based
15 on your assessment of what was available and
16 what wasn't available through these services,
17 right?
18 A I did my analysis, and essentially
19 the entire testimony I gave this morning did
20 not try to measure the effects of hold backs
21 on either a copyright standpoint or the
22 effects on consumer pricing.

1 So I can say that I didn't
2 quantify it. I did not try to quantify it.
3 Had I, I would have needed to do a lot more
4 research to get a complete understanding of
5 the hold-back principles.
6 But since my analysis doesn't
7 measure in anyway the hold-back aspect, it is
8 conservative; it doesn't matter why it's being
9 held back.
10 Q But to the extent you gave the
11 impression that the reason why tracks aren't
12 available was because record companies prefer
13 to hold back tracks, the fact is that you're
14 not, as you're sit here today, aware as to
15 whether given tracks are held back because of
16 problems clearing sound recording rights as
17 distinguished from publishing rights; isn't
18 that right?
19 A I am not aware of how much fo the
20 hold back is from which source, but I stand by
21 what I said that my estimate is conservatives
22 because of hold backs, regardless of the cause

1 of the hold back, In one case it might affect
2 the contracts here, but it obviously is
3 affecting the music that is being made
4 available that is of value to the webcasters,
5 and is ultimately of value to the customers.
6 MR. STEINTHAL: Your Honor, I'd
7 move to strike. I'm just trying to get a yes
8 or no answer as to whether his prior answer
9 gave a certain impression or not. It was an
10 invitation to go into everything he went into.
11 CHIEF JUDGE SLEDGE: I am going to
12 deny that motion. I'm not clear that it's
13 that much addition.
14 MR. STEINTHAL: Just trying to move
15 it along, Your Honor.
16 CHIEF JUDGE SLEDGE: Well, in that
17 case ¦
18 (Laughter.)
19 BY MR. STEINTHAL:
20 Q Now on this issue, one more thing,
21 you testified either in your written statement
22 or in your deposition that an example of this

1 difficulty of clearing sound recording rights
2 was, you personally noticed, did you not, that
3 certain albums you could some but not all of
4 the tracks on an album; remember that?
5 A Yes.
6 Q Wouldn't that be an indication,
7 given that the sound recording rights on the
8 album are likely hold by one sound recording
9 owner, that the reason you couldn't get
10 certain tracks would be because of the
11 publishing rights associated with certain
12 tracks within that album?
13 A Not necessarily. It could well be
14 that the ¦ particularly a newly released
15 album, the sound recording copyright holder
16 might want to generate interest in the album,
17 and offer essentially the ability for
18 customers to sample it through an on-demand
19 service, but not satisfy their entire taste
20 for the album through the on demand service.
21 Q Let's stick with hold backs here
22 for a minute.

1 Is your understanding the reason
2 that the labels request hold backs ¦ by the
3 way this is usually a 90-day or temporary hold
4 back provision, right?
5 A In some case it is; in some cases
6 it is not.
7 Q But the general hold back feature
8 that you were referring to was a hold-back
9 feature, was it not, that would enable record
10 companies to sell in the physical market or
11 the permanent download market for a certain
12 period of time before tracks would be released
13 to on demand streaming and limited download
14 services; isn't that right?
15 A No.
16 Q Well, is it your understanding
17 that that is one of the reasons why labels
18 have hold back rights?
19 A Yes.
20 Q And is that particular reason one
21 to try to enable them to window if you will
22 the release of their new releases so that they

1 can try to sell with the high margin product
2 in the permanent download and physical CD
3 market?
4 A Either to sell or to avoid piracy
5 or for whatever reason.
6 Q One of the reasons is to try to
7 have that initial window where they can
8 capture the largest margin in the sale of
9 permanent downloads or physical CDs, correct?
10 A Yes.
11 Q And that's in part because they
12 view these on demand streaming conditional
13 download services ¦ your benchmark market ¦ as
14 substitutional to some degree of sales of
15 permanent downloads and physical CDs, correct?
16 A On some albums and some
17 circumstances, they probably do.
18 Q Now going back to the benchmark
19 market, it's true, is it not, that your
20 benchmark market's services are all on demand
21 streaming conditional download services which
22 do advertise themselves as offering a very

1 comprehensive universe of sound recordings
2 that can be accessed on demand; correct?
3 A That's true of most of them. But
4 there are some that are much more tailored, or
5 niche providers of service, a couple of which
6 I included in my regression analysis, and
7 tried to address that part of the market.
8 Q I'm talking about the 17 companies
9 that you used as your benchmark services.
10 Those are all services that offer to the
11 public and advertise that they offer a
12 comprehensive catalog of a million plus tracks
13 for consumers to access on demand; correct?
14 A I think I answered this before,
15 and I think I said, other than the word
16 "comprehensive," which I don't know whether
17 that appears in their public ¦ their web pages
18 ¦ they do certainly advertise the number of
19 tracks. The numbers for many of them are a
20 million or more, and they do represent that
21 they're covering a wide range of music; I
22 agree with that.

1 Q And would you agree, then, that
2 for those services in particular, they in
3 order to offer a product that can be
4 competitive with the other 16 of your 17
5 companies, effectively have to have a license
6 from each of the big four major labels?
7 A I would say to that that appears
8 to be the business model they've chosen,
9 correct.
10 Q And in fact I was mentioning
11 before the 17 agreements in yo8ur benchmark
12 market that you rely upon, those are actually
13 17 agreements entered into by just five
14 different companies, aren't they?
15 A I was going to include that
16 correction in my answer, but I decided to hold
17 back.
18 Q So it's a fairly tight market that
19 you have analyzed for purposes of your
20 benchmark market, isn't it?
21 A It's a ¦ well, indeed it is a
22 tight market in the sense of there are a small

1 number of large companies that are webcasters,
2 and a small number of companies that are the
3 owners of the copyrights.
4 Q Let's talk about how large these
5 companies are for a minute. How large is
6 Napster LLC?
7 A I don't know.
8 Q Do you know what their
9 capitalization is?
10 A Not at Napster, no.
11 Q Do you know the name of the
12 company that owns the stock or the principal
13 stockholdings in Napster LLC?
14 A No, but I do know of others, and I
15 do know how large they are.
16 Q Stick with me first on that.
17 A Sure.
18 Q You don't know how large Napster
19 LLC is, right?
20 A No, I don't.
21 Q What about Music Net? Do you know
22 who owns Music Net?

1 A I do not know. I get confused,
2 quite frankly, of the MusicNet, MusicMatch and
3 so forth, which one is under which music
4 service umbrella now, so I don't know
5 specifically from MusicNet.
6 Q Well, it's good, maybe I can
7 refresh your recollection.
8 A Okay.
9 Q Napster LLC is the successor to a
10 company called Pressplay, is it not?
11 A I do not ¦ did not recall that.
12 I'll take that.
13 Q Well, in all your reading abou9t
14 this industry which you told us about, can you
15 tell us who the first two companies were that
16 got into the on demand streaming conditional
17 download service business, your benchmark
18 markets?
19 A I cannot.
20 Q Isn't it true, sir, or do you just
21 not know, that the first two entrants into
22 this market were companies owned either

1 entirely or substantially by the major record
2 labels?
3 A I do know that the record company
4 labels were involved in some initial efforts
5 in this market. I don't know the order in
6 which and the percentage of ownership of which
7 the particular record labels had in the
8 particular music services. I don't recall
9 those facts.
10 Q Are you familiar with the fact
11 that all of the licenses you've observed for
12 purposes of your benchmark market are
13 derivative of agreements entered into between
14 companies that were owned by the labels,
15 entering into agreements with their
16 shareholder owners?
17 A I would not accept the terminology
18 of saying they are derivative of previous
19 contracts. These are contracts between
20 independent webcasters, and independent web
21 companies. They are negotiated freshly by the
22 two parties to the negotiation.

1 So the fact that there might be
2 certain precedents does not in my mind make it
3 a derivative.
4 Q You would agree with me that the
5 50 percent rev share that is common among all
6 these agreements has been in place since the
7 very first of these on demand streaming
8 limited download services came into the market
9 in 2001; isn't that right? Or do you just not
10 know?
11 A I don't recall what is before any
12 of the contracts that I saw, and as I said, I
13 focused on the market and its most recent
14 information of the contracts that had been
15 entered into frankly the last two years or so.
16 That's in my mind the most relevant
17 information.
18 Q Well, I'm still going to stick
19 with probing all this stuff you read about
20 this market.
21 A Sure.
22 Q So are you familiar, yes or no,

1 with the fact that the first two entities to
2 offer these kinds of on demand streaming
3 conditional download services were companies
4 called Pressplan, which was owned by Sony and
5 Universal, and MusicNet, which was owned by
6 the then-other three major labels, BMG, EMI
7 and Warner, along with Real Networks; does
8 that ring a bell?
9 A I think it rings a bell because
10 you asked about it a couple of minutes ago.
11 And as I said I don't recall the specifics of
12 the early stages of the business and the
13 nature of the ownership.
14 I undoubtedly read about it, but I
15 did not recall specifics of that nature.
16 Q And you never considered or
17 factored into your analysis, I gather, the
18 relationship between the major record
19 companies at the outset of this market with
20 the only two entities that existed in the
21 market at the beginning of its growth;
22 correct?

1 A I did not then, and I would not
2 now based on what you've just told me.
3 Q Okay, those are two of the
4 companies.
5 The other three companies, who are
6 the co-parties to these agreements upon which
7 you relied, who are they?
8 A From when ¦
9 Q From the list of 17?
10 A From the list of 17 there was Real
11 Networks, which provides Rhapsody. There was
12 Yahoo. And also there's a service that Yahoo
13 offers, I believe, MusicMatch. There is AOL
14 which also has a trade name, I forget whether
15 it's MusicNet or Music something. And there
16 is Virgin Music Service.
17 Q Let's go back.
18 The 17 agreements that are your
19 benchmark model, don't include anything from
20 Yahoo other than the MusicMatch agreement,
21 right?
22 A Well, that is how Yahoo gets the

1 music.
2 Q Now it does, but MusicMatch
3 entered into that agreement when it was
4 MusicMatch before it was acquired by Yahoo,
5 correct?
6 A I believe there have been some
7 more recent agreements with Yahoo.
8 Q Now I'm looking down the list, AOL
9 is not on the list. Are you referring to
10 MusicNet at AOL?
11 A Well, that's what I just said,
12 yes, Music ¦ I wasn't sure of the name, but I
13 believe it was MusicNet, yes.
14 Q Is MusicNet a service that is
15 available to the public directly?
16 A Directly to anyone who wants to
17 subscribe to AOL?
18 Q No, I mean directly from MusicNet?
19 A No.
20 Q Do you know whether the service
21 that is offered by AOL is any different than
22 the service that was offered by Real Networks

1 prior to the launch of the Rhapsody service?
2 A Prior to the launch of the
3 Rhapsody, not as we're talking about right
4 now. I don't know. I know what it is
5 compared to Real Networks now.
6 Q Well, are you familiar with the
7 fact that the MusicNet's service is what's
8 called the white label service that is
9 distributed by any number of companies?
10 A Yes, I do know about white label
11 servicing.
12 Q Well, which os the benchmark
13 companies or benchmark agreements that you are
14 offering are white labeled by MusicNet through
15 third parties?
16 A White labeled and then sold to
17 third parties? I don't recall sitting here
18 which ¦ how many are of which nature.
19 Q And MusicNow, what's MusicNow?
20 A I don't recall.
21 Q The contract date on your
22 attachment A, to your report, says that the

1 MusicNow agreement was dated in 2003.
2 How big was MusicNow in 2003, any
3 idea?
4 A I do not know.
5 Q Any idea who the owners were?
6 A I don't recall.
7 Q And the MusicMatch deals that you
8 have on your list ¦ and by the way, as I go
9 through the list, I think there is one ¦
10 there's a ¦ two, three MusicNow agreements,
11 one from 2002, one from 2003, and one from
12 2005.
13 But you rely on all three of those
14 during that time period, correct?
15 A I think as I testified I'm relying
16 on all of them, that are in this list. But I
17 did observe that if you take the most recent
18 agreements you are generally going to get
19 higher prices.
20 Q On portable ones, not necessarily
21 on non-portable; isn't that right?
22 A Well, I think particularly if you

1 look at the pro rata subscription fees, the
2 prices that are above 2.50 for the non-
3 portable, with the exception of one entered
4 into in 2004, there's 2005 and there are 2004
5 and 2005 and ¦ 2004 and 2005, those are the
6 later contracts.
7 Q let me go back to your testimony
8 about how big all these companies were on the
9 buyer's side. We talked about MusicNet, we
10 talked about Napster, and we talked about
11 MusicNow.
12 How big was MusicMatch before it
13 was acquired by Yahoo?
14 A I don't recall. I have seen what
15 the price paid for it was, but I do not recall
16 how large it was at the time of entering into
17 any contracts.
18 Q And then the other company on the
19 list is Real Networks.
20 A Yes.
21 Q Do you know how large that company
22 is?

1 A I have reviewed their 10-K
2 recently, and I offhand do not recall the size
3 of the company. It's growing. It features a
4 number of different services. It's from my
5 standpoint an active major participant in the
6 market.
7 Q The biggest of all the five that
8 we've been talking about?
9 A I think Yahoo is the biggest in
10 the market. Yahoo is the biggest by far of ¦
11 I would say in the Internet space, there's
12 maybe AOL and Google, Yahoo is an extremely
13 large company with a market capitalization of
14 over $40 billion.
15 Q Again, sticking with attachment A,
16 the word, Yahoo, doesn't show up on it, does
17 it?
18 A No. Again, Yahoo is now the party
19 that is providing these services in the
20 market, and they are using it under contracts
21 that are entered into here.
22 So it indicates their use of the

1 copyrighted music.
2 Q Well, sir, who negotiated the
3 MusicNet deal ¦ strike that.
4 You are familiar with the fact
5 that Yahoo Music Unlimited is actually powered
6 by MusicNet, right? Yahoo has nothing to do
7 whatsoever with the negotiation of the sound
8 recording rights underlying that service;
9 isn't that right?
10 A I believe it's MusicMatch.
11 Q No, I'm talking about Yahoo Music
12 Unlimited. Is it your testimony that Yahoo
13 Music Unlimited is powered by MusicMatch?
14 A No, it's not my testimony. If you
15 could ask me questions about which music
16 service sitting here right now can I remember
17 which ones powers which service, I can't tell
18 you. I've said that.
19 What I can say, and rather than
20 trying to pass a memory test, is that there
21 are major ¦ these are the contracts in the
22 market. This is how the music is being bought

1 and sold int eh market today. These are the
2 willing buyers and sellers. These are the
3 same willing buyers and willing sellers in the
4 benchmark target and the target market.
5 Q Sir, let's talk about Yahoo Music
6 Unlimited. It's in your regression analysis;
7 it's on all your charts, right?
8 A Right.
9 Q I'm asking you specifically as you
10 sit there today, do you know whether Yahoo had
11 anything to do with the negotiation of the
12 sound recording licenses that underlie the on
13 demand streaming and conditional download
14 service that is offered by Yahoo Music
15 Unlimited?
16 A I do not know whether it was
17 before or after they acquired the white label,
18 or whatever you want to call the company that
19 has the rights. They are using those rights
20 today.
21 Q Sir, if you would please answer
22 the question.

1 Do you know whether Yahoo had any
2 role in negotiating the sound recording rights
3 underlying the service that is known as Yahoo
4 Music Unlimited?
5 A I do not know.
6 Q Is it your testimony that it's
7 offered, it's a service that was negotiated by
8 MusicMatch?
9 A There is a MusicMatch negotiation.
10 I think I already answered and said I don't
11 recall the specific ownerships as I sit here
12 today of which music copyright is now being
13 used or negotiated by any of the particular
14 services.
15 I'm looking at the market, and
16 what is used in the market to provide these
17 services.
18 Q And is it irrelevant to you who
19 the entity is that negotiates with the sound
20 recording copyright owners to get the rights
21 underlying the agreements that are on your
22 attachment A to your report?

1 A That's what's in the market, and
2 that's in the benchmark market, and that's
3 what would be in the noninteractive market; it
4 doesn't matter. That's the market evidence.
5 Q Let me ask you this: would you
6 agree that in respect of the sales of licenses
7 to their respective catalogs to on demand
8 services that comprise your benchmark market,
9 the big four record labels don't really
10 compete against one another?
11 A I missed the first part of the
12 question. Could you give it back to me, sir?
13 Q I'm asking you whether you would
14 agree with the proposition that when it comes
15 to the sales of licenses to their respective
16 catalogs to on demand services in your
17 benchmark models, the big four record
18 companies compete against one another or not?
19 A They ¦ I would say that for the
20 most part they can't ¦ they only compete to
21 the extent that they are offering
22 differentiated products in the same market.

1 They cannot compete for the sale of the same
2 copyrighted material. There is only one owner
3 of the copyright.
4 Q So hypothetically if you accept
5 that these benchmark services effectively must
6 get a license from all four of the major four
7 record companies, then you'd agree in that
8 hypothetical that the big four record
9 companies don't compete against each other in
10 the licensing of their repertoires to those
11 services, correct?
12 A Well, I would not agree with that.
13 Q Well, that's not a competition
14 between two or more sellers of the exact same
15 copyrighted works, right?
16 A There is not that type of
17 competition. There is, I would say it's not
18 very ¦ from marketplace evidence ¦ that
19 customers value particular sound recordings,
20 and don't see one record of a particular
21 artist as a substitute for another artist's
22 record. There is not that type of intense

1 competition.

2 There is more than one set of

3 recordings available on the market. They do

4 provide some degree of competition. Does that

5 very intense in the sense of selling very

6 similar products? No.

7 Q It's true, is it not, that there

8 is really no price competition as between each

9 of the four major record companies in that

10 hypothetical, isn't it, because the universe

11 of what they're offering as you say is totally

12 differentiated one from the other?

13 A I wouldn't ¦ I'm trying not to

14 argue here, but I'm just trying to state sort

15 of what I think are the economic conditions

16 here, which is, there is a degree of com

17 petition which economists would refer to as

18 competition between differentiated products,

19 so even though things are not the same, it

20 does have an impact on the price of the other

21 differentiated product.

22 So does it have no effect on the

1 price? No, I cannot agree with that. Does it
2 have a major effect on price? Do we see a lot
3 of intense price competition anywhere in the
4 market among these highly differentiated
5 products? No, we don't.
6 Q So in this hypothetical market, if
7 a music service wants to offer a particular
8 song sung by a particular artist to which
9 there is a particular unique copyright, the
10 buyer must buy that from a single copyright
11 holder; correct?
12 A Yes.
13 Q In essence conveying monopoly
14 power to the licensor of the sound recordings,
15 where a licensee is seeking to offer on demand
16 access to a comprehensive catalog?
17 A Correct.
18 Yes, with ¦ let me just explain if
19 you don't mind. I'll give a firm yes, there
20 is monopoly due to the ownership of the
21 copyright, which is the nature of copyright
22 law.

1 Q Now you're aware, are you not,
2 that in the CARP decision and the librarian
3 decision that you've cited several times in
4 your testimony, the CARP and the librarian in
5 the first proceeding stated that the
6 hypothetical market to be replicated by this
7 board is a hypothetical competitive market;
8 correct?
9 A I think you'll have to show that
10 to me. I don't recall putting it that way.
11 Q Okay.
12 MR. STEINTHAL: Your honor, since
13 we are approaching the break, and I'm going to
14 get these exhibits, I think that maybe we can
15 take a break now. I'll get the exhibits
16 ready, and we'll go right into it after the
17 lunch break, if that is okay with you.
18 CHIEF JUDGE SLEDGE: Mr. Handzo?
19 MR. JOSEPH: Your Honor, before we
20 recess I just have one housekeeping matter.
21 CHIEF JUDGE SLEDGE: Yes, sir.
22 MR. JOSEPH: We have learned that

1 one of the artist witnesses has refused,
2 knowing of the court's two orders to produce
3 tax returns, has refused to produce tax
4 returns. That's MS. Fink, who will be
5 testifying on Wednesday.
6 We will be ¦ actually have filed
7 this morning ¦ a motion to strike the
8 financial portions of her testimony, and a
9 motion to limit her testimony to nonfinancial
10 matters.
11 I'm not suggesting that we get
12 into an argument on that motion now. We have
13 informed SoundExchange, we actually spoke with
14 them, and we did confirm this morning, and I
15 just wanted to know if I could have leave to
16 hand up copies of those motions before I file
17 today so that they can be considered on an
18 expedited basis. And obviously SoundExchange
19 will have an opportunity to respond as well.
20 CHIEF JUDGE SLEDGE: Certainly you
21 may give us courtesy copies of what you have
22 filed.

1 MR. HANDZO: Since Mr. Joseph is
2 doing housekeeping, I wanted to as well.
3 Obviously we will respond in
4 writing. MS. Fink, I believe, did produce tax
5 returns, but not personal returns; she
6 produced her business returns. In any event,
7 we will certainly respond in writing on that.
8 One other housekeeping matter that
9 I wanted to raise, and that relates to the
10 schedule on Thursday.
11 We had intended to bring Dr.
12 Brynjolfsson back hopefully to complete his
13 testimony that day. You will recall that Mr.
14 Smith was handling that examination. He is
15 actually not available on Thursday to complete
16 it.
17 So with the court's permission, I
18 believe we were going to draft Mr. Pirelli to
19 impersonate Mr. Smith. And I just wanted to
20 alert the court to that, in case anyone was
21 concerned about that.
22 CHIEF JUDGE SLEDGE: We'll address

1 that when it arises.
2 I don't know if that causes
3 problems or not.
4 MR. SMITH: Your Honor, I have
5 compelling reasons why I need to be out of
6 town that day, and I would hate to have the
7 redirect opportunity lost by not being here
8 that day. If we can get some kind of guidance
9 from the board about whether we'd be able to
10 accommodate them, I'd appreciate it in
11 advance.
12 CHIEF JUDGE SLEDGE: Can't do that.
13 I don't have enough information to do that.
14 MR. SMITH: Is there some other
15 information that you need, Your Honor?
16 CHIEF JUDGE SLEDGE: I don't know
17 if Mr. Pirelli has been present during all the
18 evidence. I don't know if anybody has any
19 objection to switching in the middle of a
20 witness. That's not an easy matter to
21 resolve.
22 MR. HANDZO: Perhaps, Your Honor,

1 we'll confer with counsel and we can provide
2 that information to the court.
3 CHIEF JUDGE SLEDGE: All right.
4 Well recess until 2:00 o'clock.
5 (Whereupon at 12:29 p.m.
6 the proceedings in the
7 above-entitled matter
8 went off the record to
9 return on the record at
10 2:03 p.m.)
11 MR. HANDZO: Before we begin, if I
12 could just address the issue that we left off
13 with, I promised that I would canvass the
14 present counsel with respect to Mr. Pirelli
15 substituting for Mr. Smith.
16 I believe there is no objection
17 from counsel, and I can represent to the court
18 that Mr. Pirelli was here for virtually all of
19 Dr. Brynjolfsson ¦ the part that he hasn't
20 been here for, he's read the transcript. So
21 he will be fully prepared.
22 So with that information I would

1 ask the court to permit us to allow Mr.
2 Pirelli to complete the redirect so that Mr.
3 Smith can attend to his family obligations.
4 CHIEF JUDGE SLEDGE: And to what
5 extent of redirect are you anticipating? Let
6 me ask Mr. Smith then.
7 MR. SMITH: Your Honor, I think we
8 were looking at something in the range of half
9 an hour, or 45 minutes, something like that.
10 That'd be my best estimate.
11 CHIEF JUDGE SLEDGE: That's a
12 difficult call to make.
13 All right, we'll grant that
14 request.
15 MR. HANDZO: Thank you very much.
16 MR. STEINTHAL: Thank you, Your
17 Honor.
18 CONTINUED CROSS-EXAMINATION
19 BY MR. STEINTHAL:
20 Q Before the break. Dr. Pelcovits, I
21 asked you about the hypothetical market
22 standard set forth in the librarian decision.

1 And I'm going to show you what I was referring
2 to. MR. STEINTHAL: I'd mark as
3 Services Exhibit No. 54 a copy of the
4 librarian's decision in the first part.
5 (The aforementioned
6 document was marked for
7 identification as
8 Services Exhibit No. 54)
9 BY MR. STEINTHAL:
10 Q I'd ask you to take a look, if you
11 would at page 245, 244, the numbers are in the
12 upper left-hand corner, there's a paragraph
13 where the librarian states: In this
14 configuration of the marketplace, the willing
15 buyers of the services which may operate under
16 the webcasting license. The MCA compliance
17 services, the willing sellers are record
18 companies, and the product consists of a
19 blanket license from each record company which
20 allows us of that company's complete
21 repertoire of sound recordings.
22 Because of the diversity among the

1 buyers and the sellers, the CARP noted that
2 one would expect a range of negotiated rates,
3 and so interpreted the statutory standard as
4 the rates to which absent special
5 circumstances most willing buyers and willing
6 sellers would agree in a competitive
7 marketplace.
8 Do you see that?
9 A I do.
10 Q Does that refresh your
11 recollection that the CARP and the librarian,
12 as part of their interpretation of the willing
13 buyer-willing seller standard focused on a
14 hypothetical competitive marketplace?
15 A I don't read it that way, and
16 that's not how I read the CARP. This is
17 quoting the CARP, and the CARP decision adopts
18 willing buyer-willing seller as the existing
19 buyers and sellers, and it says in fact that
20 an alternative view where there would be
21 multiple providers of the same copyright would
22 not be consistent with a competitive market.

1 Q So that your testimony, sir, that
2 the willing buyer-willing seller standard does
3 not require this panel to establish the rates
4 that have been established in a hypothetical
5 competitive market?
6 A Well, when you say, hypothetical
7 competitive, that, first of all I think the
8 term hypothetical refers to the fact that
9 there would be a marketplace absent the
10 statutory license, so that part, hypothetical,
11 in my mind, refers to a hypothetical market in
12 that sense.
13 The term of whether it's a
14 competitive market, the CARP accepted,
15 adopted, the market as it stood with
16 essentially the same players that are there
17 today.
18 Q Sir is it your testimony that the
19 CARP adopted the market as it stood and simply
20 replicated rates that were found in the
21 market?
22 A It adopted, and interpreted the

1 willing buyers and the willing sellers as the
2 willing buyers that we talked about are the
3 webcasters and others users of the license.
4 And from the standpoint of looking at any
5 issue of market power among the record
6 companies, it accepted that the record
7 companies, as they were, were the willing
8 sellers.
9 Q You are familiar with the fact,
10 are you not, that the CARP rejected 25 of the
11 26 benchmark agreements proffered by the RAA?
12 You're familiar with the fact that one of the
13 reasons those agreements were rejected was
14 because of the lack of comparable bargaining
15 power or market power as between the entities
16 in the subject negotiations?
17 A In many cases, that was the RIAA
18 negotiating, and that was a single seller.
19 Q But you would agree with me, would
20 you not, that the reason that the panel
21 rejected those agreements was because they
22 found that the market as it was reflected a

1 market in which there was not equal bargaining
2 power?
3 A I don't know if that was the exact
4 words they used. They did reject those, and
5 rely on and interpret the entire structure of
6 this issue of the market as the existing
7 buyers and existing sellers.
8 Q Let me be precise here, because I
9 don't really understand what you said.
10 Is it your view that the
11 hypothetical market to be replicated by this
12 panel is a hypothetical competitive market or
13 not?
14 A It's a hypothetical market. There
15 is ¦ it does not ¦ I don't believe in any way
16 this ¦ these judges have to try to construct
17 a hypothetical version of the market with some
18 competition above and beyond what's in the
19 marketplace today.
20 And the competition that is there
21 is among the four major record companies and
22 several others. It is a competitive market,

1 and has been found to be such.
2 And I see no reason to create a
3 hypothetical different than what's there
4 today.
5 Q Are you testifying, after what you
6 said this morning, before lunch, that the
7 market in which an on demand streaming service
8 finds itself in negotiating with the four
9 major labels is a competitive market?
10 A It is a bargaining and a
11 negotiation between a willing buyer and a
12 willing seller where the structure of the
13 seller's industry is workable competitive ¦
14 Q No ¦ I'm sorry.
15 A Let me finish please. And where
16 the notion of applying some textbook
17 competitive standard to that cannot really
18 work because you have individual copyrights
19 held by individual companies.
20 Q So your testimony is that the
21 panel is obligated to set the rates that we
22 would find on a hypothetical workably

1 competitive market?

2 A No, my ¦ I would state it very

3 simply. My belief is that the court can use

4 the same standard that the CARP adopted in its

5 previous decision, which was to interpret the

6 willing sellers as the companies that

7 currently own these copyrights.

8 That market can be characterized I

9 believe in general these companies are in a

10 workably competitive industry. That does not

11 mean that in particular negotiations there are

12 not different weights of bargaining power.

13 Bargaining power does not ¦ if the

14 presence of bargaining power does not mean

15 that a market is not workably competitive.

16 Q Well, you would agree, then, that

17 the four major labels in their individual

18 negotiations with on demand streaming and

19 conditional download services have far more

20 market power and bargaining power in that

21 negotiation than does any particular service,

22 correct?

1 A I'm sorry, I missed the end of
2 that.
3 Q You would agree, would you not,
4 that the individual labels in their
5 negotiations with an individual on demand
6 streaming and conditional download service
7 have far greater bargaining power than the
8 individual service does, right?
9 A If you use the term bargaining
10 power, I would agree with you, that in most
11 cases that will be true, yes.
12 Q Now going back to the quote I read
13 you from the librarian's decision, do you just
14 disagree with what the librarian said at the
15 end, the words, in a competitive marketplace?
16 A I don't disagree, because the
17 entire report of the CARP and as accepted by
18 the Librarian of Congress, accepted the market
19 as it was back when the decision was rendered
20 with essentially the same sellers and the same
21 buyers.
22 So it seems to me inconceivable

1 that they could have something in mind in a
2 particular quote of a hypothetical situation
3 that's something different than the way the
4 market functions and the way the market works.
5 Q Well, if the CARP and the
6 librarian were content to take the market as
7 it was, then why in the world did they reject
8 25 of the 26 agreements, which were all based
9 on the market as it was?
10 A That was RIAA negotiating, and the
11 market as it is does not now, and in a context
12 of a nonstatutory license, would not allow
13 RIAA to negotiate as a collective for all of
14 the copyright holders.
15 Q You are familiar with the tack
16 that it was the RIAA that urged the agreements
17 between the RIAA and all those 26 webcasters
18 as the benchmark agreements; right?
19 A I don't recall. But I do recall
20 that they had those agreements, and they were
21 presented, and they were rejected.
22 But the market willing buyer and

1 willing seller as I described it is what the
2 CARP adopted.
3 Q The last CARP relied on one of
4 those agreements between RIAA and a purported
5 willing buyer; correct?
6 A It relied on one of those, and it
7 also stated a standard. And the standard is
8 very clear.
9 Q Is it your testimony that it
10 stated a standard that it then rejected?
11 A No.
12 Q Now if the CARP and the librarian
13 were content on taking the market as it was,
14 do you view that as therefore ¦ strike that.
15 Is it your testimony, sir, that
16 this panel should take the market as it is, to
17 use your words, and not make any adjustments
18 that might exist between differences in
19 bargaining power that would exist as between
20 the willing buyers and statutory license
21 webcast negotiations versus the willing buyers
22 in your benchmark market?

1 A That's a long question. Let me
2 make sure I understand it.
3 Q Let me rephrase it. I'll cast it
4 as a hypothetical, and then you can tell me
5 what you think.
6 Hypothetically, assuming that the
7 buyers in your benchmark market have less
8 bargaining power because of the nature of the
9 service they offer, compared to buyers in a
10 statutory webcasting market, is it your
11 testimony that no adjustment would need to be
12 made for the differences in bargaining power
13 between your benchmark market and your target
14 market?
15 A I honestly can't answer that as a
16 hypothetical. I believe the markets are
17 essentially the same. Same willing buyers,
18 same willing sellers, same copyrighted
19 material.
20 I think Dr. Brynjolffson addresses
21 the issue of bargaining, and that is not the
22 way I used to analyze the market.

1 The market is there. There is
2 market evidence, and there are transactions
3 between willing buyers and willing sellers.
4 Q I understand. But you posit this
5 theory based on your benchmark market, and
6 you've asserted just now that the bargaining
7 power in your judgment is the same, is that
8 your word, the same or essentially the same?
9 A Essentially the same.
10 Q Okay, I'll come back to that.
11 I'm asking you as an economist to
12 hypothesize a situation where the benchmark
13 market is such that the buyers have greater
14 bargaining power than the buyers in the target
15 market.
16 Wouldn't you have to make an
17 adjustment in your model to accommodate the
18 difference in bargaining power between the
19 benchmark market buyers and the target market
20 buyers?
21 A I can only answer that as a
22 hypothetical. There is not enough there for

1 me to say exactly what that means.
2 Again, bargaining power is a very
3 loose term, and I did not look at this as
4 trying to weigh a bargaining model of the
5 markets. I believe that the market is
6 primarily valuing this as unique pieces of
7 intellectual property that are being made
8 available and provided through these
9 agreements.
10 Q Sir, turn to page 10 of your
11 written statement, okay?
12 Is it correct that in this first
13 full paragraph on page 10, where you talk
14 about the use of benchmark rates, you say, a
15 market brings together buyers and sellers and
16 solves the equations that specify the
17 willingness of these parties to engage in a
18 transaction at a particular price.
19 You go on to say the buyers
20 equation consists of the sum of the
21 willingness to pay of all the existing and
22 potential customers of a service. Their

1 willingness to pay is dependent among other
2 things on the characteristics of the service;
3 the income of the customers; and the prices of
4 substitutes, and complements to the service.
5 That's all correct in your mind,
6 right?
7 A Yes.
8 Q Then you go on to say the
9 willingness of a seller to offer a service at
10 a particular price is in large measure a
11 function of its costs; the effective sales of
12 one service on sales of other services sold by
13 the same company; and the intensity of
14 competition in the marketplace, both in the
15 short and in the long run.
16 You said that, and it was accurate
17 when you said it, right?
18 A Yes.
19 Q I'm asking you to posit a
20 situation where your willing buyers, in the
21 benchmark market, have different bargaining
22 leverage than the willing buyers in your

1 target market, either to use your language
2 because of the price of substitutes is greater
3 for them, or for example competition in the
4 marketplace is less for them.
5 A And the question is, sir?
6 Q Wouldn't you have to make an
7 adjustment in your model, based on your own
8 testimony, if those factors reflected
9 different supply and demand characteristics as
10 between the buyers in the benchmarket market
11 and the buyers in the target market?
12 A And my answer is, not in the way
13 that I built my model. My model is not a
14 bargaining model. It is valuation from the
15 consumer side. And it accepts the rates as
16 the result of an interaction between willing
17 buyers and willing sellers.
18 Q Is it your testimony that if the
19 supply and demand characteristics affecting
20 the buyers in your benchmark market are
21 different than the supply and demand
22 characteristics affecting the buyers in your

1 target market, you don't care?
2 A I didn't say that.
3 Q Well, then, let's assume it that
4 way. Let's assume that the supply and demand
5 characteristics, in the benchmark market, for
6 the buyers, are different than the supply and
7 demand characteristics for the buyers in the
8 target market.
9 Wouldn't you need to make an
10 adjustment for those differences?
11 A If the demand characteristics are
12 different, you would need to make an
13 adjustments, and I've made adjustments based
14 on demand characteristics.
15 Q In what respect have you made
16 demand characteristic adjustments?
17 A In the entire treatment of the
18 issue of interactivity.
19 Q So you're saying that apart from
20 the issue of the difference in characteristics
21 ¦ and let me be really specific here. You say
22 here in this very paragraph the willingness to

1 pay is dependent among other things on the
2 characteristics of the service; the income of
3 the customers; the prices of substitutes ¦
4 those are all separate things, right?
5 A Yes.
6 Q Okay.
7 Now I gather that the
8 interactivity of the service is a subset of
9 the characteristics of the service; right?
10 A That's correct.
11 Q Okay. Now, again, putting aside
12 differences in the characteristics of the
13 service, I'm asking you to assume that the
14 supply and demand characteristics of the
15 market in which the buyers find themselves in
16 the target market is different than the supply
17 and demand characteristics in the benchmark
18 market.
19 Is it your testimony that you
20 don't have to make an adjustment for that?
21 A My testimony is that, I state it
22 right here, you are looking at, as best you

1 can, at the demand and supply characteristics
2 of the market. And as I said, there are a lot
3 of things that influence that. And if you can
4 capture them, and if you can model them
5 properly, you try to take account of them.
6 I cannot say how a hypothetical
7 change in one part of one particular feature
8 or aspect of the service would translate into
9 a different adjustment.
10 And I did not model the bargaining
11 process, nor do I believe that the need for or
12 the demand for one record label's services
13 rather than another is going to have a very
14 big effect on price.
15 Q Well, what about if we look at the
16 record company, if we look at the buyers as I
17 was positing, what if the buyers in the target
18 market had more substitutes, or cheaper
19 substitutes, than the buyers in your benchmark
20 market? You would imagine all other things
21 being equal, the price of goods to a buyer
22 that has more substitutes or cheaper

1 substitutes, would be less, than in a market
2 where they have less of those substitutes,
3 correct?
4 A Yes, and I think it would be
5 reflective, and I agree with you, that it
6 would be reflected essentially in the demand
7 elasticity for the services; absolutely.
8 Q But you would want to make an
9 adjustment for that difference in the demand
10 equation if your analysis found in fact that
11 there was such a difference; would you not?
12 A If I had the data, if there was a
13 way to fit it into a model, if I could
14 compute, perfectly compute, elasticities, I
15 would do it, given the data available and the
16 extent of the market at this point in time, I
17 adjusted what I felt was necessary.
18 Q Wait a minute, now I'm very
19 concerned.
20 Are you saying that even if you
21 discern evidence of a difference, in the
22 demand characteristics of target market and

1 benchmark market, if you don't have sufficient
2 data to calculate or measure the difference,
3 you're not going to do that?
4 A Well, if I cannot take account of
5 anything. No analytical technique can handle
6 every real world complication. If you could,
7 the art and science of economics would be
8 entirely different. You have to work with
9 observable data. You have to work with
10 measurable things, which is why, for example,
11 I included a simulation to deal with the
12 substitution issue.
13 Overall I would say that my
14 judgment not to be focused very much on the
15 nature of the competition among the record
16 companies is because the competition among
17 record companies is primarily not about price.
18 They don't lower and raise their prices
19 primarily in reaction to each other's prices,
20 because they're selling different goods.
21 Q You'd agree with me, would you
22 not, that the buyers in a target market and a

1 benchmark market may have different levels of
2 substitutability, and therefore, different
3 demand curves?
4 A The buyers might have different
5 demand curves, I agree with you. And I cannot
6 capture, there is not sufficient data to
7 estimate the demand curves reliably.
8 I did make an assumption and a
9 calculation based on similar elasticities. If
10 there are significantly different substitutes
11 available in the two markets, they are not in
12 a ¦ if they are in very different markets
13 facing very different conditions, then you
14 would have to make an adjustment of
15 elasticities, and that would carry through in
16 the recommended rates.
17 Q And that would carry through ¦
18 A That would carry through to a
19 difference in the recommended rates.
20 Q Okay. Now as you said before, you
21 assumed that the demand characteristics of the
22 buyers in your benchmark market and the buyers

1 in your target market were essentially the
2 same; I think those were the words you used.
3 A Generally, yes.
4 Q Are you familiar with the fact
5 that in the deposition testimony of one of the
6 record company executives, Mr. Larry Kenswil,
7 testimony was given that addressed the
8 difference in the demand characteristics
9 between your very benchmark market and the
10 target market?
11 Are you familiar with that?
12 A I'm familiar with the ¦ I'm
13 familiar that there was a deposition. I don't
14 recall that specific point.
15 Q Well, let's take a look at Mr.
16 Kenswil's deposition.
17 It has already been marked as
18 Services Exhibit No. 22. And I'd like you to
19 take a look at pages ¦ start on page 71. Hold
20 on one second if you don't mind.
21 Okay, take a look at 71, line 7.
22 The question is, is it your view that on

1 demand streaming and conditional download
2 services have to get licenses from all the
3 major labels in order to offer consumers a
4 desirable subscription on demand streaming
5 conditional download service?
6 Answer: I think in order to
7 compete they need to have the competitive
8 catalog. Whether some of the smaller majors
9 are necessary, I don't know, but I think they
10 need a competitive catalog. It would be hard
11 for them to compete with holes in their
12 catalog,
13 Question: When you say compete,
14 you mean compete with other on demand
15 conditional streaming download services?
16 Answer: Correct, that's correct.
17 Then skipping down ¦ sorry.
18 Okay, at the bottom of 74, sorry,
19 bottom of 73, top of 74, then the question is:
20 Let me go back to ask you this question with
21 respect to non-on demand Internet radio
22 services.

1 Bottom of 73, actually 74. It's
2 hard to see the numbers here, because they are
3 very tiny. But the bottom of page 74, line
4 22, question: Let me go back to ask you this
5 question with respect to non-on-demand
6 Internet radio services.
7 Is it your view that non-on-demand
8 Internet radio services have to have a license
9 from all the major labels in order to offer a
10 desirable product?
11 Answer: No.
12 Question: Why is that?
13 Answer: Because radio doesn't play
14 everything, and you could program very good
15 radio stations from a much smaller supply of
16 music than the entire universe of music and
17 have a very satisfying program service.
18 Now, did you consider in
19 connection with your testimony the fact that
20 Mr. Kenswil of Universal had made the
21 distinction that he made in his deposition
22 testimony between ¦ excuse me ¦ the supply and

1 demand characteristics of your benchmark
2 market, and your target market?
3 A When I prepared my testimony, this
4 was obviously not taken. I've seen a lot of
5 this discussion here from Yahoo witnesses,
6 where they essentially say they need the music
7 for whether it's on demand or the statutory
8 services.
9 And I believe that there is not a
10 major difference in the ability of the music
11 service to substitute one record label's plays
12 for another.
13 And furthermore, and I would add
14 this, and I think it's a crucial point, you
15 don't see a lot of competition on price. And
16 I think that's explained one page earlier by
17 Mr. Kenswil, which I can read and say, since
18 people don't pay different amounts for access
19 to the different licensed catalogs, we are not
20 competing on the price to consumer.
21 That's not the way in which
22 competition takes place; it's not on price.

1 Q Dr. Pelcovits, are you familiar
2 with the fact that the Launchcast Internet
3 radio service operated for more than a year
4 without music from the Universal Music Group
5 catalog?
6 A I do not recall that.
7 Q Would that affect your judgment as
8 to whether in fact a radio service operating
9 under the statutory license has an equal or
10 essentially the same demand curve with respect
11 to its situation operating under a statutory
12 license, and that of a buyer in your benchmark
13 market?
14 A In order to try to take account of
15 that, I would have to see how successful that
16 service was, and whether ¦ and again, if this
17 is a statutory service, I don't understand why
18 they didn't have something available to them.
19 Q Are you familiar with the fact
20 that Universal sued Yahoo, claiming that its
21 Internet radio service crossed the line
22 between non-interactivity and interactivity?

1 A I am familiar that there is
2 litigation over that, but that does not say
3 that they did not provide a service which
4 satisfied the statutory requirements, and had
5 the entire library of music.
6 Q Let's go back to the hypothetical.
7 Strike that.
8 In any event, in doing your model,
9 you made no adjustment for any differences in
10 the demand curve that would affect buyers in
11 the target market versus buyers in the
12 benchmark market; correct?
13 A Except with respect to
14 interactivity, that's correct.
15 Q Take a look while you have the
16 librarians' decision in front of you, take a
17 look at page 45 to 48.
18 A I have it.
19 Q The upper left-hand corner, the
20 first paragraph says, in choosing this
21 approach the panel did not accept the 26
22 voluntary agreements at face value. It

1 evaluated the relative bargaining power of the
2 buyers and sellers; scrutinized the
3 negotiating strategy of the parties;
4 considered the timing of the agreements;
5 discounted any agreement that was not
6 implemented; eliminated those where the
7 service paid little or no royalties; where the
8 service went out of business; and evaluated
9 the effect of a service's immediate need for
10 the license on the negotiated rate.
11 Ultimately it gave little weight
12 to 25 of the 26 agreements for these reasons,
13 and because the record demonstrated that the
14 rates in these license reflect above-
15 marketplace rates, due to the superior
16 bargaining position of the RIAA or the
17 licensees' immediate need for a license due to
18 unique circumstances.
19 Does that in any way reflect your
20 recollection that the librarian was concerned
21 about relative bargaining power between
22 licensees and licensors in the hypothetical

1 market to be created?
2 MR. HANDZO: Let me object. This
3 has been asked and answered. We've already
4 been over those agreements with this witness.
5 CHIEF JUDGE SLEDGE: Mr. Steinthal?
6 MR. STEINTHAL: I'm just asking him
7 whether that refreshes his recollection about
8 what the librarian said. He said he went
9 through the court report and the librarian
10 report quite a bit.
11 CHIEF JUDGE SLEDGE: Sustained.
12 BY MR. STEINTHAL:
13 Q Wouldn't you agree, sir, that
14 anything that affects the demand and supply in
15 the market should be considered in comparing
16 the benchmark and target markets?
17 A Yes.
18 Q And that those factors should be
19 considered in evaluating the comparability of
20 the asserted benchmark and target markets?
21 A Yes.
22 Q And you'd want, as you said, to

1 measure and to adjust for any differences
2 between the supply and demand characteristics
3 of the benchmark and target markets?
4 A If you can.
5 Q Now, you acknowledge the
6 possibility, do you not, that the hypothetical
7 market to be replicated in these proceedings
8 is one populated by a large number of record
9 companies each selling a small percentage of
10 the total available universe of sound
11 recordings; isn't that right?
12 A It could be done that way; that's
13 certainly a possibility.
14 Q But you didn't do it that way?
15 A I did not.
16 Q Dr. Pelcovits, I gather not every
17 market is a legitimate candidate for a
18 benchmark market; correct?
19 A I'd agree with that.
20 Q There comes a point where another
21 market just doesn't serve as a legitimate
22 benchmark; correct?

1 A Correct.
2 Q For example where differences in
3 the markets are too difficult to capture and
4 measure; correct?
5 A Too ¦ I would say too difficult to
6 capture or measure, or based on judgment, they
7 are considered to be important and difficult
8 to measure.
9 Q I'm not sure I understood that.
10 Is it correct that you would find
11 inappropriate a benchmark market where the
12 differences between the benchmark and the
13 target markets are too difficult to measure?
14 A I would not agree that that is
15 necessarily the case.
16 Q Would that be one consideration in
17 determining whether a benchmark market is
18 inappropriate?
19 A Well, I think it would be a
20 consideration I would be concerned about if I
21 first passed a threshold of a judgment that
22 this was a significant factor.

1 I think you can always come up
2 with things you can't measure, You are never
3 going to have a benchmark if you say, gee, we
4 can't measure something. So there is a degree
5 of judgment, of trying to find something
6 that's satisfies certain criteria, and allows
7 measurement of things that your judgment says
8 are the most important things.
9 Q But at some point, if the
10 difficulty in measuring differences between
11 the market, benchmark market and target
12 market, becomes a substantial issue, then
13 you'd agree that that is a consideration in
14 determining whether to accept or reject a
15 benchmark market?
16 A In terms of difficulties of
17 measuring, or just difficulties of assessing?
18 Q Both.
19 A I think it's extremely hard to
20 answer in the abstract. You can posit almost
21 ¦ and say things are different about anything.
22 So yes, there are times in which a market is

1 not a good benchmark because you don't have a
2 good enough hold on the things that are
3 important.
4 Q Now, I'll press this one more
5 time. If you have a handle on differences
6 that you identify between the target market
7 and the benchmark market, and by differences,
8 I mean material differences, but you are
9 unable to measure those differences, wouldn't
10 that be a consideration in determining the
11 appropriateness of a benchmark market?
12 A I'm almost in agreement with that,
13 so let me just put a little bit of a ¦ amend
14 that a little bit. If you said you had a
15 handle that there were differences, and you
16 had a sense they were important, and you could
17 not measure them, then you would not want to
18 use it as a benchmark.
19 And I'll add, it always comes down
20 to compared to what? There is always a need
21 to do something.
22 Q Now, did you consider in your

1 analysis what the limits are of a benchmark
2 market in terms of its potential applicability
3 to this case?
4 A Implicitly, yes.
5 Q Did you consider the prior CARP
6 and librarian decision in evaluating the
7 limits of an appropriate benchmark market?
8 A I did, although I have to say, the
9 market was very different then; the type of
10 agreements were very different. So it's hard
11 for me to get a sort of lot of guidance on
12 that.
13 Q You say the type fo agreements
14 were very different. Are you familiar with
15 the fact that the RIAA, apart from its 26
16 agreements it had negotiated with webcasters
17 operating under the statutory license, also
18 put into evidence 115 agreements between
19 individual labels and entities not operating
20 under the statutory license?
21 A I am aware of that.
22 Q Are you familiar with the fact

1 that there were three agreements put on that
2 were agreements with subscription webcasters
3 of the same nature as you've relied upon in
4 your benchmark market?
5 A Yes, and those were put in but not
6 analyzed.
7 Q Your testimony is that the CARP
8 didn't analyze the evidence?
9 A I'm saying the RIAA did not
10 present an analysis, as far as I know, of the
11 nature of those agreements, and how to make
12 any adjustments to the benchmark.
13 So I think, I would say, if you're
14 going to put in a benchmark, it has to be
15 analyzed, and should be analyzed by the party
16 that submits it.
17 Q Does it comport with your
18 recollection that the RIAA put in those
19 agreements, including three agreements from a
20 subscription webcasting market, to corroborate
21 its position that the benchmark agreements it
22 was relying upon, between the RIAA and certain

1 webcasters, were correct?

2 A As I said, I believe they did put

3 in those agreements. I don't recall exactly

4 how they presented their case, but I do know,

5 they did not present an analytical treatment

6 of the benchmark, or of those agreements as a

7 benchmark.

8 Q Let me ask you to take a look at

9 what we've marked as Services Exhibit 56 and

10 57.

11 (Whereupon the

12 aforementioned documents

13 were marked for

14 identification as

15 Services Exhibits Nos.

16 56 and 57)

17 MR. STEINTHAL: We're a little bit

18 out of order simply because we're trying to

19 premark things, Your Honor. We can mark these

20 55 and 56 if you like, but I just assume for

21 speed purposes, the panel is okay with marking

22 these as 56 and 57.

1 CHIEF JUDGE SLEDGE: As long as
2 they're marked.
3 MR. STEINTHAL: Okay.
4 BY MR. STEINTHAL:
5 Q Exhibit 56 is an excerpt from the
6 proposed findings of fact and conclusions of
7 law that the Recording Industry Association of
8 America in the first CARP, and Exhibit 57 is
9 one of the subscription services agreements
10 referred to in those proposed findings.
11 MR. STEINTHAL: Your Honor, this
12 exhibit was marked as restricted in a prior
13 CARP, so I think you ought to consider these
14 exhibits under seal, unless the RNA wishes to
15 change its designations.
16 MR. HANDZO: Before Mr. Steinthal
17 proceeds, if I can just raise an objection.
18 As Mr. Steinthal points out, these
19 were designated as restricted by the RIAA in
20 the last hearing. We at Jenner & Block do not
21 have access to restricted materials from the
22 last proceeding. The protective order from

1 the last proceeding recited that the materials
2 from that proceeding could be used only for
3 that proceeding, and were supposed to be
4 destroyed by the parties after that
5 proceeding, except I believe counsel was
6 allowed to keep one ¦ or a couple of copies
7 for the record.
8 But number one, the protective
9 under that CARP precluded the use of materials
10 in that CARP for any other proceeding; that's
11 the first problem.
12 The second problem is at the
13 outset of this case, on behalf of Jenner &
14 Block, I requested from the parties to the
15 prior CARP access to restricted materials from
16 the CARP, and I was refused access to those
17 materials.
18 So these are materials that have
19 never been supplied to Jenner & Block as the
20 counsel for SoundExchange; indeed, opposing
21 counsel has refused to allow it.
22 Given the provisions of the

1 protective order, and the fact that we have
2 not been allowed to have access to them, I
3 would submit that it's inappropriate to use
4 those materials here.
5 CHIEF JUDGE SLEDGE: Mr. Steinthal?
6 CHIEF JUDGE SLEDGE: Your Honor, I
7 am unaware of the request or response. I
8 don't doubt it for a moment if Mr. Handzo is
9 representing that that occurred, though I was
10 certainly not the one to give the response.
11 I can probably navigate around
12 this without use of the actual exhibit from
13 the prior CARP, and just using the public
14 record version of the RIAA proposed findings.
15 So I think that in light of Mr.
16 Handzo's representation, I certainly would
17 like to work around that, and I'll withdraw
18 these exhibits and work off of a public
19 version of the proposed findings.
20 Is that all right with you?
21 MR. HANDZO: That's fine.
22 MR. STEINTHAL: And in that respect

1 the ¦ if you don't mind I will question the
2 witness only off the proposed findings and the
3 public versions thereof.
4 MR. HANDZO: Well, I will just
5 note, I don't have a copy of the public
6 version of those findings.
7 MR. STEINTHAL: You'll see, I'm not
8 going to go into any restricted material.
9 MR. HANDZO: I'm just looking at
10 this document. The entire document is marked
11 restricted. I don't see any part of it that
12 appears to be unrestricted.
13 MR. STEINTHAL: Well, the table of
14 contents is not restricted.
15 MR. HANDZO: Well, all I can say
16 is, I'm looking at it and it says restricted
17 at the top.
18 MR. STEINTHAL: We will replace
19 this with a version of the excerpt that is a
20 public record version.
21 MR. HANDZO: I understand Mr.
22 Steinthal's point. I think my response is, I

1 think if they're going to ask the witness
2 questions, they ought to have the public
3 version to give him, not a restricted version.
4 I have no way to know what was restricted and
5 what wasn't. All I can see is that the entire
6 document that I have now been handed says
7 restricted on it.
8 MR. STEINTHAL: Well, certainly I'm
9 in a position to waive whatever objection was
10 made previously so that you can look at the
11 restricted of this excerpt of the RIAA's own
12 post-trial findings.
13 CHIEF JUDGE SLEDGE: It's a little
14 late for that.
15 These exhibits have been withdraw.
16 I don't know what the issue is.
17 BY MR. STEINTHAL:
18 Q Dr. Pelcovits, are you aware ¦
19 CHIEF JUDGE SLEDGE: Are you going
20 to refer to these exhibits?
21 MR. STEINTHAL: No, not if they're
22 not ¦ not if I don't have a public record

1 version of it right this second.
2 CHIEF JUDGE SLEDGE: Thank you.
3 Please proceed.
4 BY MR. STEINTHAL:
5 Q Is it consistent with your
6 recollection in reviewing the proceedings of
7 the prior CARP that the RIAA in fact relied
8 upon among other things agreements between
9 MusicNet and recording industry members as
10 corroborative evidence of its casein the first
11 CARP?
12 MR. HANDZO: I just want to be
13 clear. Is Mr. Steinthal representing that
14 that material was unrestricted in the prior
15 CARP? If it wasn't, there's certainly no way
16 the witness could have seen it, and it's
17 unfair to ask about it.
18 MR. STEINTHAL: I think the
19 references are in the public version of the
20 CARP decision that these agreements were
21 relied upon, not the exact rates, but the fact
22 that subscription webcasting services were

1 relied upon is a matter of public record.
2 MR. HANDZO: I have no objection to
3 the extent that Mr. Steinthal wants to examine
4 about what's in the CARP decision and what it
5 says about those agreements
6 WITNESS: If I understand the
7 question now, is, am I aware there were
8 agreements from the on demand markets
9 submitted by RIAA as part of their case; the
10 answer is yes.
11 BY MR. STEINTHAL:
12 Q Did you take into consideration in
13 propounding your model here that subscription
14 services agreements of the same nature as
15 those you are relying on here were offered and
16 rejected by the prior CARP?
17 A I don't regard it at all to be the
18 same thing, but I have not just submitted
19 agreements. I have used the agreements to
20 perform an economic analysis.
21 My reading of the CARP decision is
22 that they did not reject an analysis based on

1 those agreements.
2 Q Let's go back to the librarian
3 decision for a minute, if you would go to page
4 45, 257, upper right-hand corner, the second
5 full sentence, the librarian says, it,
6 referring to the CARP, rejected the agreements
7 between RIAA and non-DMCA-compliant services
8 because the rates in those agreements were for
9 rates beyond those granted under the statutory
10 license.
11 Did you give any consideration to
12 the fact that both the CARP and the librarian
13 rejected the non-DMCA-compliant webcaster
14 agreements with individual labels because they
15 involved different rights?
16 A Yes, they rejected taking a rate
17 without performing any analysis to apply the
18 benchmark. And it's not a benchmark. From
19 what I understand, this is saying you can't
20 use another rate and just bring that into this
21 and adopt it for the statutory service, and I
22 agree with that.

1 Q Did you make any ¦ strike that.
2 How if at all did you take into
3 account the panel's and the librarian's
4 rejection of the subscription webcasting
5 agreements in the prior CARP in connection
6 with your analysis?
7 A I took it upon myself to not say
8 that the court should adopt the rates in the
9 interactive market without just on their own,
10 without undertaking or without making an
11 adjustment. And a lot of my testimony deals
12 with the adjustment. It says, don't take
13 these rates; use this as a benchmark. And
14 there is a vast difference between saying,
15 adopt rates from a different market without
16 any adjustments, and then taking those rates
17 as a benchmark and performing an analysis in
18 order to use the benchmark. It's totally
19 different.
20 Q Well, are you familiar with the
21 fact that certain actual proposed percentage
22 of revenue rates that were reviewed by the

1 first CARP, were rejected as above market
2 rates?
3 A I don't recall that specifically.
4 Q Take a look at the librarian's
5 decision again.
6 A Okay.
7 Q Go back to 45-258. I'm not going
8 to read the whole thing again, but at the end
9 of the passage that I read to you before, the
10 librarian refers to the CARP having given
11 little weight to 25 of the 26 agreements for
12 these reasons, and because the record
13 demonstrated that the rates in these licenses
14 reflect above market place rates.
15 Does that refresh your
16 recollection that in fact various rates had
17 been presented that were rejected as above
18 marketplace rates?
19 A Can you point where in the
20 document this is? You gave me the page.
21 Q 45-248, upper left-hand corner,
22 probably about 20 lines into it.

1 A I agree, they rejected these rates
2 because they said they were above market
3 rates.
4 Q And again, on page 45-245, in the
5 middle column, in the paragraph starting in
6 essence, right in the middle, do you see the
7 reference to the sentence, in fact the panel
8 found that when RIAA negotiated with less
9 sophisticated buyers who could not wait for
10 the outcome of this proceeding, the rates were
11 above market value and therefore not
12 considered by this CARP.
13 Is that another reference to above
14 market value?
15 A That's what it says; I agree.
16 Q Now are you familiar with the fact
17 that the actual percentage of revenue rates
18 that were rejected as above market were
19 agreements that were at 15 percent of revenue
20 and 11 percent of revenue?
21 A I don't recollect that exactly,
22 but I do not try to interpret the discussion

1 of above market rates as involving an analysis
2 of the percentages applied. It's simply
3 saying, these are not rates, and these are not
4 contracts we're going to use as a benchmark,
5 because they didn't like the way the
6 agreements were arrived at; not because they
7 felt the percentages were wrong.
8 Q Well, is it your testimony that
9 you would ignore a prior CARP determination
10 that an 11 percent of revenue rate and a 15
11 percent of revenue rate are above market in
12 doing your analysis of what a willing buyer-
13 willing seller rate should be in the same
14 marketplace?
15 A If I wanted to go back and review
16 the entire record of the previous proceeding,
17 I would try to analyze exactly what was the
18 nature of the contracts that were presented to
19 the CARP at that time. Just saying
20 percentages without looking at the contracts,
21 at the services, and accounting for the market
22 developments over the last several years, I

1 can't say what that means.
2 Q You don't think it's worth at
3 least a gut level check on what your model
4 generated to look at what the actual
5 percentage rates that were rejected in the
6 last CARP as above market rates?
7 MR. HANDZO: Objection; asked and
8 answered. We're just arguing here.
9 CHIEF JUDGE SLEDGE: Sustained. I
10 might add that that's not part of his model,
11 going from the last rate set, and therefore
12 not part of his direct testimony.
13 MR. STEINTHAL: Your Honor, I think
14 it goes to the credibility of his model, if he
15 did or didn't consider certain matters that
16 the RIAA certainly was aware of.
17 CHIEF JUDGE SLEDGE: That was part
18 of the last model we had, not part of this
19 model.
20 BY MR. STEINTHAL:
21 Q I counted at least a half a dozen
22 times when you refer to the CARP panel

1 decision in your report and in your testimony.
2 You referred to it quite a bit,
3 did you not?
4 A I did.
5 Q But I gather you didn't refer to
6 those parts of it that rejected the 25 of the
7 26 agreements?
8 MR. HANDZO: Objection; it's been
9 asked and answered.
10 CHIEF JUDGE SLEDGE: Sustained.
11 BY MR. STEINTHAL:
12 Q Now you sought to rely on
13 agreements, in your benchmark market, that are
14 currently in force, correct, to the best ¦
15 A To the best of my knowledge, yes.
16 It's a changing process, and things are
17 updated all the time. But I tried to get a
18 fair snapshot.
19 Q I gather you also wouldn't want to
20 rely on agreements if you had evidence that
21 they were part of an effort on the label
22 licensor's part to artificially raise market

1 prices, correct?
2 A I am sorry, I don't understand the
3 question.
4 Q Well, if you were presented with
5 evidence that the very agreements upon which
6 you're relying were part of an effort on the
7 part of the licensor to set an artificially
8 high price, you wouldn't want to rely on those
9 agreements, would you?
10 A Again, that doesn't have any
11 meaning to me, because I don't know what you
12 mean by an artificially high price. A willing
13 seller is going to try to get as much as he
14 can, and there is nothing artificial about it.
15 Q What about if you had evidence
16 that the agreements were the products of
17 activities alleged to be in violation of the
18 anti-trust laws?
19 A There are ¦ if you simply say it's
20 an allegation, I would have to say I can't
21 answer that without knowing the specifics, and
22 since I'm not going to conduct an anti-trust

1 investigation on my own I would generally
2 expect to rely on the decisions of an anti-
3 trust agency rather than simply an
4 investigation.
5 Q Are you aware of evidence that the
6 very agreements upon which you rely have been
7 the subject of two Department of Justice
8 investigations, one that terminated in
9 December, 2003, and another that's ongoing?
10 A I know there is ¦ I've read in the
11 newspapers that there are anti-trust
12 investigations going on, and there are anti-
13 trust investigations going on all the time of
14 all sorts of industries. And I did not try to
15 second-guess what the result of those
16 investigations will be. An investigation is
17 not a finding.
18 Q Are you aware of a decision from
19 Chief Judge Patel in the Northern District of
20 California several weeks ago finding that two
21 fo the major four labels deliberately misled
22 the government in the prior investigation

1 ending in 2003 concerning the very agreements
2 about which you are relying on?
3 A I'm not aware of that decision.
4 MR. STEINTHAL: Can we mark this?
5 (The aforementioned
6 document was marked for
7 identification as
8 Services Exhibit No. 58)
9 BY MR. STEINTHAL:
10 Q I'd have you look at what's been
11 marked as Services Exhibit No. 58.
12 Have you read in the press or been
13 made aware of the actual decision of Judge
14 Patel, which resulted in an order requiring
15 certain labels to reproduce materials from the
16 original Department of Justice investigation?
17 MR. HANDZO: Objection, asked and
18 answered. He's already testified that he's
19 not aware of the decision.
20 CHIEF JUDGE SLEDGE: I don't
21 believe he said that; overruled
22 WITNESS: I am not aware of the

1 decision.
2 BY MR. STEINTHAL:
3 Q Were you to become aware that
4 there was evidence that the labels had sought
5 to collude to raise prices and fix prices in
6 the online distribution market, would that
7 affect your willingness to rely on the
8 benchmark agreements that you've relied on?
9 A If these are allegations, and
10 evidence presented by one party at one time,
11 no. As I said, there are allegations and
12 investigations all the time.
13 I would take it into account if
14 there was a decision that clearly presented
15 that and clearly made that finding, but I
16 don't know of any decision that says that.
17 Q Are you familiar with the fact
18 that many of the agreements upon which you
19 rely have most-favored-nations provisions in
20 those agreements?
21 A I am.
22 Q Are you aware of allegations that

1 those most-favored-nations provisions resulted
2 in the setting of prices in violation of the
3 anti-trust laws by the big four labels?
4 A I am aware of that general claim.
5 Q Would it concern you if you came
6 if you became aware that the very agreements
7 on which you rely contained MFN provisions
8 that enabled the major labels to set prices in
9 violation of the anti-trust laws?
10 A If they had provisions the court
11 found to be in violation of the anti-trust
12 laws, it would concern me. The MFN provisions
13 in these contracts that I have reviewed and
14 considered, the competition consequences I
15 believe are not a competitive problem, and are
16 not anti-competitive or collusive.
17 Q Take a look at page seven of Judge
18 Patel's decision.
19 In the first full paragraph, she
20 says, it is not the present of MFNs in
21 particular agreements which undermines the
22 truth of the disparate licensing

1 representations, but rather, the consistent
2 practice of including MFNs in all license
3 agreements.
4 This practice, which UMG does not
5 deny, is fundamentally incompatible with UMG's
6 assertion that the licenses granted by the
7 labels show a wide dispersion of terms.
8 Did you do any kind of an analysis
9 of the MFNs in the benchmark market agreements
10 upon which you relied to determine whether
11 they were used in a manner incompatible with
12 an assertion that the licenses showed any kind
13 of price dispersion?
14 A No, I did not try to analyze or
15 assess what the term, wide dispersion, even
16 means. I think what I did, and I repeat what
17 I said, I did look at the major of these MFN
18 provisions, and they are not ¦ I'll
19 underscore, not ¦ the type of MFN provisions
20 that are typically a problem for anti-trust
21 considerations.
22 Q But you didn't take your analysis

1 any further than that?
2 A I'm not exactly sure what you mean
3 by that.
4 Q You didn't take your anti-trust
5 analysis any further than your conclusion upon
6 reviewing the MFNs in this agreement that they
7 didn't appear to be a problem?
8 A In general, I did not, no.
9 Q Going back to page three, in the
10 first full paragraph Judge Patel refers to
11 MusicNet and Pressplan as two joint ventures
12 involving the major labels.
13 Does looking at that refresh your
14 recollection at all as to the original entries
15 into the on-demand streaming and conditional
16 download markets?
17 A I think you have already refreshed
18 my memory this morning.
19 Q Now are you familiar with the fact
20 that there's been a number of class action
21 lawsuits filed in the last six months against
22 the four major labels contending that the very

1 agreements upon which you're relying in your
2 benchmark market are part of a conspiracy in
3 violation of the anti-trust laws?
4 A Well, I can say that I'm aware
5 there are a number of class action lawsuits.
6 My recollection, and this is based on press
7 reports, is that these primarily deal with
8 downloads, although I can't say for sure they
9 don't include these type of agreements as
10 well.
11 MR. STEINTHAL: Your Honor, can we
12 mark this?
13 (Whereupon the
14 aforementioned document was marked for
15 identification as
16 Services Exhibit No. 59)
17 BY MR. STEINTHAL:
18 Q I'd ask you to take a look at what
19 we've marked as Services Exhibit No. 59.
20 MR. HANDZO: If I can just
21 interject, I would just object to this line of
22 cross-examination. I think we all learned in

1 first year in law school that complaints are
2 not evidence, they're allegations. Complaints
3 from a class action lawyer, I don't see how
4 that has any probative value here to the
5 cross-examination.
6 CHIEF JUDGE SLEDGE: Counsel?
7 MR. STEINTHAL: Your Honor, I think
8 it's relevant to determine whether he has
9 evaluated aspects of the market relating to
10 the varying agreements upon which he is
11 relying that have been the subject of anti-
12 trust challenge.
13 CHIEF JUDGE SLEDGE: But hasn't
14 that been covered? What will another
15 allegation add to that cross-examination?
16 MR. STEINTHAL: Well, the witness
17 just said in response to my last question that
18 he thought it related to download markets, and
19 not the markets for on demand streaming
20 conditional download.
21 I just wanted to point out that a
22 passage in this particular complaint that it

1 appears to direct some of his allegations
2 against the very agreements entered into by
3 MusicNet and Napster, previously known as
4 Pressplay.
5 CHIEF JUDGE SLEDGE: I'll overrule
6 the objection for that limited answer. BY MR.
7 STEINTHAL:
8 Q Take a look if you would at
9 paragraph 33 of Exhibit 59.
10 Do you see where there are
11 references to MusicNet and Pressplay?
12 A I do.
13 Q As part of the market for online
14 music that is referred to in the complaint?
15 A I do.
16 Q Let's move on to a different topic
17 if you would.
18 Now, I believe you'd agree with
19 the proposition that price is essentially the
20 result of everything that goes into the demand
21 and supply curves, is it not?
22 A Yes.

1 Q Now you had no facts about how the
2 separate components of the benchmark on demand
3 subscription services were broken down by the
4 buyers or the sellers as among those
5 components; correct?
6 A Well, I did, and that's the nature
7 of the hedonic regression. It's not looking
8 at demand and supply in a ¦ forgive me ¦ a
9 general equilibrium sense, but it is looking
10 at the prices, and attributing portions of the
11 prices to different characteristics.
12 Q As a factual matter, before you
13 embarked on your regression analysis, it's
14 correct, is it not, that you had no facts
15 about how the actual buyers and the actual
16 sellers valued the individual components of
17 what was being offered in your benchmark
18 market; correct?
19 A I would say that the factors would
20 be either ¦ have to come from looking at the
21 prices as I did, and working backward in a
22 sense; and the other would be to look at

1 surveys of any sort which are not really good
2 at capturing measurements of value.
3 I have seen a number of surveys of
4 the online music industry done by Arbitron.
5 I did not rely on those surveys to try to come
6 up with measurements.
7 Q Arbitron being?
8 A Arbitron being the company,
9 Arbitron, that conducts media research and
10 publishes data into the public and to
11 subscribers.
12 Q Did you rely on some of the
13 Arbitron reports that you were able to
14 research?
15 A I relied on them not to try to get
16 a measure of value; I did rely on them to get
17 a sense of the developments in the industry,
18 the usage patterns, things like that. But I
19 did not try to turn them into a sort of
20 analytical tool.
21 Q Going back to my question, isn't
22 it true, sir, that what you had in terms of

1 data was as you testified earlier the amounts
2 that the services in your benchmark market
3 said they were charging to consumers, but not
4 breakout of what that total amount being paid
5 was for as between the individual components
6 of the services being offered?
7 A I think that's what the prices are
8 telling you, that you have prices of various
9 different services that are public information
10 available. Certainly they want you to buy the
11 services. I really don't know much more to
12 say other than you look on the website for
13 Rhapsody, and it presents you the type of
14 services they offer, and gives you the
15 characteristics of the services.
16 Q And that's all you have in the way
17 of information about what the price was being
18 charged for, correct?
19 A That's all I could have, and all I
20 could wish to have. I wish I could get that
21 kind of data in other cases.
22 Q And I believe you said that after

1 gathering that data, you looked at the nature
2 of the services, and you looked at who the
3 buyers and the sellers were, and that's
4 basically what you did in advance of
5 conducting your regression analysis; correct?
6 A Yes.
7 Q And I gather it's a fair statement
8 that you sought to pick a benchmark market
9 which was as close as you could find to the
10 hypothetical market that the board is charged
11 with setting a rate for, correct?
12 A That's not what I said.
13 Q Well, why wouldn't you want to
14 find a benchmark market that's as close as
15 possible to the market that you're trying to
16 set rates for?
17 A I think, I explained this morning,
18 I'd be happy to repeat it, which is, if you
19 get too close then you're not getting an
20 independent market price; you're getting a
21 price that is strongly influenced by the
22 existing statutory rate for the music

1 licenses.
2 Q Well, hypothetically, if you
3 weren't looking at services ¦ well, strike
4 that.
5 Is it your testimony that the
6 prior CARP rate was set too low?
7 A Yes.
8 Q Isn't it true, sir, that at least
9 as of the time of your deposition you had
10 never studied the issue of whether the initial
11 CARP rate was set too low?
12 A I think my testimony is saying the
13 CARP rate is too low. So I don't know what
14 you mean about having studied that. Sure.
15 MR. HANDZO: I wonder if I could
16 just ask Mr. Steinthal to clarify his question
17 because I think it might speed things along.
18 Is the question whether the CARP
19 rate was too low at the time it was set in
20 2002, or is it too low today?
21 MR. STEINTHAL: Well, it was set in
22 2002.

1 WITNESS: If there was a question
2 pending, I was going to volunteer, but I
3 didn't want to not be responding to the
4 questions, but I think it's too low. I've
5 looked at the market now. I've not tried to
6 recreate history. But my opinion is, the rate
7 should be raised.
8 BY MR. STEINTHAL:
9 Q Several fold, obviously.
10 A Yes, about threefold.
11 Q It's true, is it not, that to
12 assess whether the CARP rate was set too low,
13 at least back in 2002, you believe would
14 require a lot of thought and a lot of care in
15 constructing and testing hypotheses; is that
16 right?
17 A I have to be honest, I haven't
18 thought about trying to go back and make a
19 decision based on knowledge available in 2002.
20 The market has changed dramatically. I look
21 at the market as it is today. I realize we're
22 setting rates for now and into the future. So

1 can I say what I would have recommended had I
2 been here in 2002? I can't say.
3 Q And what specific facts do you
4 rely upon in concluding that you're not in a
5 position to say the rate was set too low in
6 2002 but you're very comfortable testifying
7 that the very same rate should be increased by
8 both the framework into a greater formulation,
9 and in terms of individual components, by some
10 two to three times?
11 A I think, as I've said, I don't
12 know what the facts were as stated knowledge
13 existed in 2002. I mean I can make some
14 surmises, but in terms of trying to sort of
15 construct a hypothetical testimony that I
16 would have given in 2002, I just can't say
17 sitting here what I would do and what I would
18 have done.
19 I can tell you, the market's
20 changed quite a lot. There's a lot of
21 evidence in the market that there was not in
22 2002. And so I'm basically saying, you're

1 asking me what I would have done had things
2 been different, and what facts I would know
3 that I needed in order to figure that out, I
4 can't say that sitting here. It's a different
5 problem than the one I've been asked to
6 address here.
7 Q The one you've been asked to
8 address by the labels?
9 A By my clients, yes.
10 Q Well, hypothetically, if you knew
11 that the prior CARP rate was in fact the
12 quintessential hypothetical willing buyer-
13 willing seller rate for entities operating
14 under the Section 114 statutory license,
15 couldn't you try to measure whatever
16 differences are appropriate up or down from
17 that benchmark in order to get to an
18 appropriate willing buyer-willing seller rate
19 in this case?
20 A I think that is basically Dr.
21 Brynjolfsson's ¦ part of his testimony. So he
22 did that; I didn't.

1 MR. HANDZO: Your Honor, I wonder
2 if I could inquire, we're almost at 3:30. I
3 wonder if it might be a good time to take a
4 break. It would be for me, I'll say that.
5 CHIEF JUDGE SLEDGE: It will depend
6 on Mr. Steinthal to make that suggestion.
7 MR. STEINTHAL: That's fine, Your
8 Honor.
9 CHIEF JUDGE SLEDGE: Depends on how
10 kind he is.
11 MR. STEINTHAL: That will be fine.
12 CHIEF JUDGE SLEDGE: We'll recess
13 10 minutes.
14 MR. HANDZO: Thank you.
15 (Whereupon at 3:29 p.m.
16 the hearing in the
17 above-entitled matter
18 went off the record to
19 return on the record at
20 3:43 p.m.)
21 CHIEF JUDGE SLEDGE: Thank you.
22 We'll come to order.

1 BY MR. STEINTHAL:
2 Q Dr. Pelcovits, you're familiar
3 with the provisions in the statute that
4 provide that the copyright royalty board may
5 consider the rates and terms for comparable
6 types of digital audio transmission services
7 and comparable circumstances under voluntary
8 license agreements negotiated?
9 A Yes.
10 Q Let me ask you some questions
11 about the comparable for a minute.
12 One of the characteristics that
13 you considered in conducting your
14 comparability analysis was the extent that the
15 libraries of music available on the benchmark
16 services were the same as the libraries of
17 music on the target services, correct?
18 A Yes.
19 Q And you concluded that there was
20 actually a difference between the two insofar
21 as ¦ because of the hold back aspects of
22 voluntary licenses between labels and your

1 benchmark market services, they actually had
2 access to a smaller catalog, at least for
3 certain time periods; correct?
4 A Yes.
5 Q Now, I believe you testified that
6 these hold back rights in the voluntary
7 agreements were actually requested and desired
8 by the label; correct?
9 A Yes.
10 Q Is it your testimony that the
11 major labels would also insist on hold backs
12 in the licensing of statutory license services
13 were it not for the compulsive licenses?
14 A I can't say. In the sense of,
15 would they try to set a contract for
16 noninteractive music which included hold back
17 provisions in the absence of the statutes? Or
18 would they not try to do hold backs? I can't
19 say exactly. I think that holding back music
20 can affect prices. Where they'd end up in
21 terms of negotiated rates, I can't say
22 exactly.

1 Q Well, if the markets were very
2 comparable, as between your benchmark market
3 and the target market, wouldn't you expect
4 that the labels would seek hold backs in the
5 target market?
6 A I'm not sure exactly how they
7 would assess it. I don't know. I've looked
8 at the issue of hold backs from the standpoint
9 of what that says about rates in the benchmark
10 market. And obviously it's different, and
11 you're selling less.
12 And I would say, everything else
13 being equal, reducing the breadth of the music
14 available reduces the price people would be
15 willing to pay for it.
16 Other than that I can't say what
17 would happen as the result of a full
18 marketplace functioning in place of the
19 statute.
20 Q Well, wouldn't you agree that if
21 labels voluntarily chose to have hold back
22 rights in your benchmark market, but didn't

1 wish to have hold back rights in the target
2 markets, that that would be indicative of
3 differences in the two markets?
4 A It would reflect something. It
5 would reflect some difference in the
6 underlying markets. I can't say for a
7 hypothetical situation what motivates it.
8 Q Well, let's do less hypothetical.
9 Are you familiar with the fact
10 that there has been voluntary agreements
11 entered into between Yahoo on the one hand and
12 Sony Music and Universal Music Group in two
13 separate transactions, which include grants of
14 rights that cover the Lankest service that you
15 place in your target market?
16 A They include Lankest and various
17 customized types of features, yes.
18 Q And are you familiar with the fact
19 that the agreements between Yahoo and Sony on
20 the one hand, and Yahoo and Universal on the
21 other, don't have hold back provisions of the
22 nature that you testified are typical of your

1 benchmark market?
2 A I didn't recall that specifically.
3 It doesn't surprise me, and I'll tell you why.
4 These are services that are very close to
5 statutory services, but not the same as, and
6 I would think that the statute and the terms
7 of the statute have a very large effect on
8 these near substitutes.
9 Q Sir, are you suggesting that if
10 Universal or Sony didn't want to have hold
11 back rights in its deal for the Lankest and
12 Lankest plus service with Yahoo, it wouldn't
13 have requested hold back rights?
14 A I don't know what they requested.
15 I don't know what tradeoffs or evaluations
16 were made at the time of the negotiations. So
17 I can't say, you know, whether they didn't
18 want it or they didn't want to take a lower
19 price that might have been required to do some
20 hold backs.
21 Q In any event, you didn't seek to
22 make any kind of adjustment for the fact that

1 voluntary agreements between Universal Music
2 Group and Sony with Yahoo for the Lankest
3 service did not have any hold back provisions,
4 whereas your benchmark market typically does
5 have hold back provisions; correct?
6 A That's correct, overall, if I
7 could just expand for a second. As I said, I
8 think I've said very much -- very clearly
9 this morning I did say hold backs are a
10 difference, not just between those Yahoo
11 agreements and the benchmark market, but
12 between the statutory rate of the benchmark
13 market. And that is a difference.
14 I said that. I said it has a
15 particular effect of making my estimate
16 conservative.
17 Q But it may also be indicative of
18 differences in the market that you didn't
19 adjust for otherwise; correct?
20 A There might ¦ there are certainly
21 differences in these markets. I have used the
22 analytical techniques that I've described to

1 try to make the adjustments that I thought
2 were the most significant, most important and
3 measurable.
4 Q But you didn't try to measure the
5 significance for noninteractive radio services
6 of Universal and Sony wanted to have their
7 product on those webcasting services as of
8 street date instead of 90 days later after a
9 hold back in the physical market; correct?
10 You didn't try to assess that one way or the
11 other?
12 MR. HANDZO: I would object. That
13 assumes facts not in evidence.
14 CHIEF JUDGE SLEDGE: Mr. Steinthal.
15 MR. STEINTHAL: I'm asking whether
16 he assessed that. Either he did or he didn't.
17 CHIEF JUDGE SLEDGE: Sustained.
18 BY MR. STEINTHAL:
19 Q Now it's correct that the
20 satellite services under their voluntary
21 agreement with SoundExchange also had no hold
22 back rights affecting the grant of the

1 plaintiff license by SoundExchange to them;
2 isn't that right?
3 A I believe that's correct, and I
4 think that would be true under the governing
5 statute.
6 Q Same is true of the preexisting
7 services, MusicChoice, the digital cable radio
8 services?
9 A Again, under the statute as I
10 understand it, there are no hold backs.
11 Q So in terms of the library of
12 music available to the licensee, and the
13 timing with which that music is made
14 available, it's correct that the statutory
15 license services before the board here are
16 closer in character to the satellite services
17 and the digital cable radio services than your
18 benchmark market services; correct?
19 A The statute requires them to be
20 blanket licenses, so they are similar in that
21 respect, which is not true of the interactive,
22 as I described and discussed before.

1 Q Is it true, sir, that you don't
2 think that the satellite radio and digital
3 cable radio services are as substitutional as
4 your on demand benchmark market services?
5 A I don't think I said that
6 anywhere.
7 Q Do you have a basis of saying so
8 one way or the other?
9 A Now you're asking me do I think
10 one way or the other?
11 Q Have you done any assessment?
12 A Oh, okay, that's a different
13 question.
14 I have not looked at that.
15 Q You do acknowledge at page 49 of
16 your report, however, that statutory license
17 webcast services are not likely to be as
18 substitutional as satellite radio; correct?
19 A I don't think that's what I said.
20 Q Well, that's the purpose of your
21 citation to the Wall Street analysts?
22 A It wasn't to deal just with

1 substitution. This was to talk in general
2 about the notion that there is an important
3 substitutional effect of any service that
4 provides a high quality stream of
5 noncommercial music to customers.
6 I don't think I judge one being
7 more than the other.
8 Q Now in your comparative analysis
9 of the nature of the services involved, as
10 between your benchmark market services and the
11 statutory license webcasters, you don't
12 consider the conditional download component of
13 the benchmark services as conveying any more
14 value than the on demand streaming, do you?
15 A I don't try to measure it
16 separately, since it's a feature of the
17 service. It's captured in the consumer price,
18 so it is picked up.
19 Q Well, would you agree that there
20 are consumer benefits and values associated
21 with the ability to obtain conditional
22 downloads in addition to on demand streaming?

1 A I expect it has some value to
2 consumers and some value to the webcasters.
3 Q And did you ¦ I'm not sure what
4 you meant on the last trailer there. And some
5 value to the webcasters?
6 A Yes.
7 Q Do the webcasters under the
8 statutory license have the right to make
9 deliveries of conditional downloads?
10 A We weren't talking about the
11 statutory service; we were talking about
12 conditional downloads of the interactive
13 services.
14 And what I said, to make sure it's
15 clear, I said yes, I think that has some value
16 to consumers. I didn't try to measure that
17 increment separately. I said also for looking
18 at that aspect of the service in the market,
19 I think it's valuable to the webcasters
20 because it can save them bandwidth costs, if
21 a customer downloads it conditionally and then
22 listens to it from his or her own computer, it

1 saves them from having to stream the song the
2 next time the customer demands it.
3 Q But you would agree with the
4 proposition that there is an additional
5 benefit to consumers associated with a service
6 that offers not just on demand streaming but
7 the ability to obtain conditional downloads,
8 correct?
9 A Yes.
10 Q And part of that benefit,
11 especially if it's a portable service, is the
12 ability to make conditional downloads of songs
13 that you acquired on an on demand basis, and
14 port them at various portable devices that are
15 capable of recognizing that digital rights
16 management system associated with those
17 conditional downloads; correct?
18 A Absolutely, and that's recognized
19 ¦ that aspect, I think that is much more
20 significant than the conditional download to
21 the computer itself. The conditional download
22 to the portable device is very important, and

1 is recognized in the market as having
2 significant value, and I picked up that effect
3 in my regression.
4 Q Now within the universe of
5 nonportable services, it's correct that you
6 didn't try to ascribe any separate value to
7 the conditional download component of what
8 they offered; correct?
9 A That's correct.
10 Q Also in connection with the nature
11 of the services, as between the target market
12 and the benchmark market, you'd agree, would
13 you not, that generally speaking the benchmark
14 market on demand services deliver higher
15 quality music than the statutory license
16 webcasters?
17 A Do you mean by higher quality
18 better bit rate or something else?
19 Q Start with higher bit rates.
20 A I don't know if that's true. In
21 fact, the subscription services that I looked
22 at all tended to have pretty high quality bit

1 rates that some of them claimed to be CD
2 quality. Whether they are or not, I don't
3 know, but they are certainly at a relatively
4 high bit rate, and intended to take advantage
5 of the broadband connections that customers
6 have.
7 Q By subscription services in that
8 answer, you meant the subscription statutory
9 webcasters, correct?
10 A I did; thank you.
11 Q And those comprise less than 10
12 percent of the current marketplace of
13 statutory license webcasters, is that right,
14 according to your understanding?
15 A It depends on how you measure it,
16 whether you measure it by customer streams or
17 value to the total amount of money being
18 collected.
19 Q Well, as measured by the number of
20 unique listeners, do you know what the number
21 is?
22 A I've only seen it ¦ I've not seen

1 a full data set. I have seen partial
2 datasets, either from Accustream. I've seen
3 it for specific services like with Yahoo, and
4 there are ¦ yes, I would say in the range of
5 90 percent of the customers, unique customers
6 are using nonsubscription services.
7 Q As measured in terms of the amount
8 of streaming hours, are you familiar with
9 whether it's 90 percent, 10 percent, or as you
10 sit here you don't know the figures one way or
11 the other?
12 A Well, the only place I've seen
13 apples to apples figures on that are from
14 Yahoo. And I don't know, this is proprietary.
15 So I do know the relationship there. And it's
16 ¦ well, I won't give the numbers ¦
17 Q Well, why don't you give the
18 number as part of this one answer, and we
19 won't clear the courtroom, because there is
20 nobody here that we really need to clear it
21 with.
22 A Okay, so as I recall the ratio of

1 the listening hours or plays is about I think
2 it's about three to one, three being the ad
3 supported nonsubscription services, one being
4 the subscription services.
5 So there is a lot more play per
6 customer from the subscription services.
7 Q And you haven't looked at any data
8 on an industry wide basis?
9 A I haven't seen any. There is ¦
10 there is, as I said, some data from the
11 Accustream, and it doesn't break it down that
12 way. And I'd also say, it gets complicated,
13 because I don't know where you fit into that
14 bifurcation a service like AOL, or XM Online,
15 which are part of a bundle of services, so
16 they are neither nonsubscription, nor are they
17 services that you can identify directly the
18 purchase price of the music service.
19 Q To the extent Dr. Brynjolfsson's
20 model ascribed 90 percent of the aggregate
21 tuning hours in 2005 to nonsubscription
22 webcasting, and 10 percent to subscription

1 webcasting, do you have any basis to dispute
2 that?
3 A I frankly don't recall how he got
4 that. I was looking at this recently based on
5 the latest discovery for ¦ and that's what I
6 saw.
7 Q And your comments on the quality
8 of the streaming and the bit rates, you gave
9 the answer as to subscription services.
10 It's generally true, is it not,
11 that the nonsubscription services provide
12 lower quality, lower bit rate streams?
13 A Quite a few of them do, yes.
14 Q And I gather you didn't try to
15 make any adjustments in your model as between
16 the quality of the streaming for your
17 benchmark services and the target market
18 services?
19 A I proposed a rate based on an
20 adjustment for interactivity. I did not make
21 an adjustment for the sound quality that
22 particular services choose now or might choose

1 in the future for their streaming services.
2 Q Now you also testified that one of
3 the characteristics you wanted to look at is
4 comparability of the buyers in a benchmark
5 market and a target market; correct?
6 A Generally speaking, yes.
7 Q And you stated this morning I
8 think that the buyers were essentially the
9 same; is that a correct statement?
10 A I don't recall my exact words, but
11 there is a significant number of buyers that
12 are the same in both markets, and the major
13 buyers and the parties on the contracts are
14 primarily services that offer statutory and
15 nonstatutory services.
16 Q Let's go back to that list of 17
17 agreements that forms your benchmark markets
18 and the five companies who are the licensees
19 under that.
20 Isn't it true, sir, that other
21 than MusicMatch, which is now owned by Yahoo,
22 all of the entities that actually did the

1 negotiating with the labels underlying your
2 benchmark model are not buyers of
3 noninteractive radio products?
4 A I know that the services that have
5 those rights, and as I said earlier I'm not
6 sure of the timing of any acquisition of
7 services, or rights by particular services.
8 But a number of those services do offer both
9 types fo webcasting; for example, Rhapsody.
10 I mentioned Yahoo. However they've gotten the
11 license. AOL offers both kinds. So there are
12 a variety of ¦ a number that have activities
13 in both markets.
14 Q Again, AOL didn't negotiate any of
15 the agreements that are part of your list of
16 17; did they?
17 A We covered that. To the best of
18 my recollection ¦ I think I said I don't know,
19 essentially, whether it was AOL or a white
20 label or something that they had used their
21 licenses.
22 Q And that was my point, that you

1 don't know as you sit here today how many of
2 the entities on your list of 17 as willing
3 buyers in those transactions were entities
4 that also, at the time they negotiated those
5 agreements, operated statutory licensed
6 webcasting; correct?
7 MR. HANDZO: Objection, it's asked
8 and answered. I think we covered this pretty
9 thoroughly earlier today.
10 CHIEF JUDGE SLEDGE: Sustained.
11 BY MR. STEINTHAL:
12 Q And I gather you'd agree, would
13 you not, that the mere fact that a parent
14 company operates two different businesses
15 doesn't make them the same for purposes of
16 your willing buyer-willing seller analysis?
17 A It doesn't necessarily make them
18 the same. But from the standpoint of the
19 analysis, I think that there are ¦ as I said,
20 many of the same companies in those
21 businesses, and I would add, and I think this
22 is important, that the ultimate consumers of

1 these music services I think as a very
2 important part of this, are the same, or
3 essentially drawn from the same pool of
4 customers.
5 It strikes me as very important
6 that you have a statutory and a nonstatutory
7 service offered by Yahoo or Rhapsody at the
8 same time to the same group of customers.
9 Is that exactly the same as who
10 did the negotiations on the date at which they
11 took place? No.
12 Q And I believe you said before that
13 the only difference between the target market
14 and the benchmark market that you ultimately
15 sought to adjust for was the interactivity
16 difference; correct?
17 A That's correct.
18 Q Now ¦
19 A Could I have just a second? I
20 adjusted for interactivity, but to the extent
21 that I think we went over this, to the extent
22 that interactive services offer conditional

1 downloads that is picked up as part of the
2 interactivity adjustment.
3 Q Okay. Now from a pure
4 comparability standpoint, you would agree,
5 would you not, that customized Internet radio
6 services are much closer statutory licensed
7 webcasters than your benchmark market
8 services; correct?
9 A Yeah, I prefer the word
10 substitutability. They are much closer
11 substitutes, yes.
12 Q And would you agree as well that
13 the satellite services and the digital cable
14 radio services are closer substitutes?
15 A I don't know if I could say that.
16 Satellite experience right now is primarily
17 being driven by use of the satellite radio in
18 automobiles, so it's ¦ to that extent it's a
19 very different use of the music.
20 And the preexisting services and
21 what went on in them, those are ¦ I consider
22 to be very old examples of what was in the

1 market then.
2 I think I saw that two of them are
3 still around, but they are not a major force
4 in the market.
5 Q But in terms of the programming
6 that's made available to consumers, wouldn't
7 you agree that the satellite services and the
8 preexisting digital cable radio services offer
9 programming more comparable than your
10 benchmark model services offer?
11 A I would ¦ there are
12 characteristics, and among them, the fact they
13 are streams of preprogammed music make them
14 more similar; that part is more similar.
15 Other parts are not.
16 Q Now you've said a couple of times
17 today that you have difficulty with making
18 reference to negotiations that are too close
19 to the statutory license; right?
20 A Yes. Too close.
21 Q I believe you claimed in your
22 written testimony that webcasters use the

1 presence of the statutory license and the
2 threat not to offer a somewhat interactive
3 radio service against the labels in order to
4 get bargaining leverage; is that your
5 testimony?
6 A I don't know if those are the
7 exact words, but it's pretty much the theme of
8 what I said.
9 Q Well, let me see if I can parse
10 that through. First of all, hypothetically,
11 if you assume that the statutory license was
12 not set too low, and contemporaneously there
13 is a service that wishes to offer an Internet
14 radio service with some degree of
15 interactivity that takes across the line from
16 noninteractive to interactive, as an
17 economist, would you have a problem with using
18 the statutory license as a starting point and
19 just measuring the difference between the not-
20 too-low statutory license rate and the
21 measurable differences between noninteractive
22 and interactive services?

1 A Well, if my goal is to determine a
2 statutory rate, and I felt the statutory rate
3 was not too low, sort of was just right, I'd
4 just look at the statutory rate, not getting
5 any additional information by looking at the
6 merely substitutable services.
7 Q Well, wouldn't you want to measure
8 whatever difference there is between you
9 benchmark market and the target market in that
10 situation?
11 A No, because my basis then for
12 saying the benchmark market is a good market
13 is that the target market is where it should
14 be. So why do I need to look at the benchmark
15 market to tell me what I've already assumed.
16 Q Well, are you assuming, then, that
17 there shouldn't be any difference in fees for
18 modest changes in functionality that take you
19 from a statutory license service to a service
20 that doesn't fall under the statutory license?
21 A No, if my goal was to try to
22 estimate the factors that caused there to be

1 some difference between the price in the
2 statutory market, and in the substitute ¦
3 closely substitutable market, then I would
4 look at that difference in price and try to
5 examine it. In terms of then, that doesn't
6 make that a better benchmark market, because
7 the justification for it being a good
8 benchmark market is that the statutory rights
9 was correct.
10 So I've accomplished nothing by
11 looking at the so-called benchmark of the
12 negotiated rates for the customized radio.
13 Q Well, hypothetically, if we knew
14 that the statutory rate for satellite services
15 that currently exist was ¦ strike that.
16 Hypothetically, if we knew that
17 the rate for satellite services as established
18 under the ¦ under the parties' agreements was
19 scientifically the right rate ¦
20 A I'm sorry, which ones?
21 Q Satellite services. Let's assume
22 that we've got a rate that we know to be the

1 quintessential willing buyer-willing seller
2 rate.
3 Is there any reason as an
4 economist we couldn't use that as a starting
5 point and then just adjust for differences
6 between the statutory webcasters on the one
7 hand and the satellite services on the other?
8 A I think I agree; I just want to
9 make sure what I'm agreeing to. I'm agreeing
10 to the assumption that we take the satellite
11 rates as the omniscient perfect rate. That is
12 a rate that satisfies willing buyer and
13 willing seller. It might not satisfy the
14 statutory standard for satellites, but let's
15 say it satisfies willing buyer-willing seller.
16 Well, then we might want to use
17 that rate, which we were commanded is the
18 correct rate for willing buyer-willing seller,
19 and use that and try to adjust that to the
20 webcaster.
21 Q There is no reason you couldn't do
22 that with any benchmark rate that you were

1 comfortable reflected a willing buyer-willing
2 seller outcome as long as you could measure
3 the differences, right?
4 A If you start with something that ¦
5 again, it comes ¦ where did that number come
6 from? If the number was given to you by the
7 omniscient authority, and you are told that
8 that is the realization of willing buyer-
9 willing seller, I'd say that's a good
10 candidate, assuming you can then make the
11 adjustments.
12 Q Okay.
13 Going back to your claim that
14 services use the existence of a statutory
15 license as leverage against labels, in
16 voluntary negotiations over the customized
17 radio, let me ask you this: Suppose in advance
18 of launching a digital radio service, an
19 Internet radio service, let's call it Service
20 A, label U sent a letter that indicated in
21 substance, I hear you're about to launch your
22 service, but it has features that we believe

1 take you outside of the statutory license. So
2 you must get a license from us if you want the
3 label to use music.
4 Are you with me so far?
5 A I'm with you so far.
6 Q Is it your testimony that the
7 ensuing discussion is one in which a service
8 has more leverage than a label?
9 A I said, I didn't base my testimony
10 off the hypothetical presence of a letter. So
11 if I can refer to the testimony itself, I
12 first cited the litigation which obviously has
13 some relationship to contract disputes.
14 JUDGE ROBERTS: What page are you
15 reading from
16 WITNESS: Oh, I'm sorry, Your
17 Honor. It starts on the bottom of page 19,
18 and continues to the top of page 20.
19 JUDGE ROBERTS: Thank you
20 WITNESS: You're welcome.
21 So I said to the extent litigation
22 is pending that creates uncertainty. So any

1 negotiation is under the cloud of litigation.
2 And then I said, even if the legal
3 status of the custom radio services were
4 perfectly clear, the fact they are a close
5 substitute means their prices will be strongly
6 influenced by the compulsory fees.
7 So this is just saying, this is a
8 very powerful influence on the price, because
9 it influences in some sense the fall back for
10 the ¦ for both the radios ¦ the webcasters,
11 and essentially for the music service.
12 In the absence of this service
13 being provided, the webcaster could provide a
14 statutory service. It doesn't have to
15 threaten it; it's simply a fact.
16 BY MR. STEINTHAL:
17 Q Let me get this right. In the
18 circumstance that I posited to you, the
19 service would have one of four choices,
20 wouldn't it, either not to go into the
21 business at all of customized radio; go into
22 business with a different product than the one

1 they've developed, meaning the statutory
2 licensed service; pay the rate that label U
3 wants; or rely on the statutory license and
4 risk infringement litigation.
5 It's one of those four choices,
6 right?
7 A I got three. Number one was go
8 into the statutory ¦
9 Q Not go into the business of
10 customized radio at all because they can't get
11 the rights voluntarily.
12 A Okay.
13 Q Second is, go into business with a
14 different product than the one they've
15 developed, meaning statutory licensing; pay
16 the label whatever the label wants; or rely on
17 the statutory license and risk infringement
18 litigation.
19 Isn't that a fair characterization
20 of the four options it has?
21 A One very important fifth one,
22 which is to negotiate with the label. And if

1 the label says I want a million dollars for
2 this, you say, no, I'm not going to pay your
3 million dollars, I'll pay you 10 percent more
4 than the statutory license, take it or leave
5 it.
6 And the record label might then
7 come back and say, we'll take it. It might
8 come back and say, we want 15 percent above
9 it. But I'm just saying, the existence of the
10 statutory rate puts a natural sort of focal
11 point of any negotiations, because to the
12 extent that the rate deviates significantly
13 from that, there is the availability of the
14 substitute in the market, which limits how
15 much anyone is going to pay for it.
16 Q And, sir, if the label says, I
17 want an advance of a million dollars, and 1-
18 1/2 or three times the statutory rate, the
19 bottom line is, the service has limited
20 choices which include either not going into
21 business or going into a different business
22 than the one that it had planned to go into or

1 risking an infringement lawsuit?
2 A And I would say the record label
3 also has limited choices. There are only so
4 many choices. Its choices can be to provide
5 the music at a price, not as much as it'd
6 like, but more than it would get if it were a
7 statutory webcaster; it can not provide it,
8 and not be willing to negotiate.
9 Again, these are two parties whose
10 alternative to trying to provide this music
11 and the limit to what they can get for this
12 music is influenced by the presence of the
13 statutory license which is going to affect
14 what services are in the market, and what
15 consumers ¦ this is ultimately driven by what
16 consumers will pay.
17 So you can demand all you want.
18 The record company can demand what it wants.
19 The webcaster can say, we're going to do this
20 or that or this.
21 But ultimately, unless there is a
22 significant difference between this service

1 and the statutory service, the consumers would
2 pay a lot more for it, it's not going to exist
3 in the marketplace.
4 Q It's not going to exist in the
5 marketplace?
6 A Absolutely. It will not exist at
7 a price that is very far away from the price
8 of services that provide webcasting under the
9 statutory license.
10 Q And by the way, as I said before,
11 if we hypothetically knew that the CARP rate
12 at the time this negotiation occurred was
13 scientifically the right willing buyer-willing
14 seller rate, you'd have no problem with having
15 that in the market, would you?
16 A Having what in the market?
17 Q The existence of a CARP rate, as
18 long as we knew it was scientifically the
19 right rate for statutory webcasts?
20 A I'm not sure I understand your
21 question.
22 Q Well, if we know scientifically

1 that the existing CARP rate reflects the true
2 willing buyer-willing seller rate, for
3 statutory licensing, then it's not going to
4 affect either too much or too little what the
5 ultimate outcome of that negotiation between
6 the label and the webcaster would be in your
7 mind, correct?
8 A I think I understand what you're
9 saying.
10 If we knew the statutory rate was
11 the right rate, then would the customized
12 radio rates be close to the right rates; is
13 that ¦
14 Q Yes.
15 A And the answer is yes. If we knew
16 what is right, then the thing that's very
17 close to it would also be close to being
18 right.
19 Q Now let's change the circumstance
20 one little bit. The webcaster says, I don't
21 want to pay your premium, because you claim
22 that my services is interactive. I'm going to

1 rely on the statutory license.
2 And then label U sues, claiming
3 $150,000 per work infringement damages for
4 thousands of tracks available on my radio
5 service.
6 How would you characterize the
7 difference if any in the negotiations that
8 would occur between the label after having
9 sued for infringement seeking damages of
10 $150,000 per track being used by the server?
11 A Let me just try to take this
12 hypothetical step by step.
13 One part of I think what you're
14 asking is, would a lawsuit affect negotiations
15 over a contract that would sort of replace or
16 ¦ I don't know what the right word is ¦
17 effectively work retroactively and eliminate
18 the lawsuit.
19 And to that extent, yes, I think
20 the presence of a lawsuit affects how people
21 value something. They are essentially betting
22 on the outcome of the lawsuit. It happens all

1 the time in settlements. The result fo a
2 settlement is bargaining over expectations,
3 based on expectations of the result of a
4 lawsuit.
5 So to that extent, yes, the
6 lawsuit affects negotiation over retroactive
7 prices.
8 Now as far as prospective prices,
9 I would think the ¦ that's more driven by
10 assuming it's sort of a pure negotiation just
11 on prospective prices, that's more driven by
12 the marketplace forces. And the marketplace
13 forces here themselves, are highly determined
14 by the existence of the statutory rate on the
15 statutory webcast services, which lead to
16 particular prices in the marketplace, and
17 limit how high the price is going to be for
18 the near substitutes.
19 Q Well, you'd agree, wouldn't you,
20 that if the plaintiff in a lawsuit says, I
21 will only settle this lawsuit if you pay on a
22 going forward basis a royalty of X, that there

1 is an opportunity for that plaintiff to use
2 the pendency of the lawsuit to influence the
3 price of the license; correct?
4 A If it becomes part of the
5 settlement negotiations, absolutely.
6 Q Did you consider, in giving your
7 testimony about how customized services can
8 use the statutory license to their benefit in
9 negotiations with the labels, the prior CARP
10 decision at tall?
11 A No, sir, I thought you were asking
12 a different question, so you'll have to re-ask
13 it. My mind went.
14 Q My question is, whether in giving
15 the testimony you gave about how customized
16 radio services are able to use the existence
17 of the statutory rate to their advantage in
18 negotiations with labels, did you consider
19 what the prior CARP decision said in any
20 respect?
21 A I have a hard time connecting A
22 and B here, but let me start with A, which is,

1 I didn't say that the statutory rate is used
2 by the web services to their advantage. I
3 described this as a market which is very
4 similar to the statutory market, and
5 therefore, is highly affected by it; it
6 affects the bargaining. But fundamentally,
7 you can look at it from the demand side, the
8 supply side, whatever, the price in the market
9 is strongly affected by the price of the close
10 substitute.
11 I can quote my testimony if you
12 want.
13 Q Well, just one second.
14 (Pause)
15 Well, you did testify, did you
16 not, that services could use the ability to
17 threaten not to take a customized service
18 license to try to get a favorable rate by
19 threatening to operate under the statutory
20 license, right?
21 A Where did I say that?
22 Q Isn't that the gist of what you

1 said in your written testimony?
2 A No. I'll read the exact sentence.
3 Q Okay.
4 A Which is, and we're on page 20,
5 the two sentences. I say: Even if the legal
6 status of the custom radio services were
7 perfectly clear, the fact that they are close
8 substitutes for the noninteractive services
9 means that their prices will be strongly
10 influenced by the compulsory fees. If the
11 copyright holders try to set a much higher
12 price for a nonstatutory customized service,
13 the music services will simply not offer these
14 services but instead limit their offerings to
15 ones that can be provided under the compulsory
16 license.
17 I don't regard that as a threat; I
18 regard that simply as a marketplace fact. And
19 in fact, even if they decided they were not
20 going to be in the business at all, the issue
21 is, for the record companies, do I get from
22 this webcaster or anoth8er webcaster, the

1 revenues coming from customers who subscribe
2 to webcasts that observe the statutory
3 requirements, or maybe I can get a little more
4 if I charge a somewhat higher price for my
5 music, and that goes and flows through to the
6 market in a somewhat higher cost to the
7 customers.
8 There's a limit to what the
9 copyright holder can charge for the music, as
10 used in the customized web services,
11 customized radio services, is ultimately
12 constrained by what customers are willing to
13 pay for those services. It's not some
14 abstract concept of bargaining that's more
15 powerful or more fundamental than what
16 customers are willing to pay for it.
17 Q Well, isn't that true of every
18 market, that the price is limited by what
19 people are willing to pay?
20 A Yes.
21 Q Now that we've at least agreed on
22 that, isn't it true that in the hypothetical

1 that you're talking about, either the service
2 is going to be willing to pay what the label
3 asks for a voluntary license for this
4 customized radio service or it has no choice
5 other than to operate a service under the
6 statutory license?
7 MR. HANDZO: Your Honor, I'm just
8 going to object. I think this has been asked
9 and answered now many times. I think Dr.
10 Pelcovits has made his views perfectly clear
11 on the bargaining with respect to custom
12 radio.
13 CHIEF JUDGE SLEDGE: Mr. Steinthal.
14 MR. STEINTHAL: I'm not sure I got
15 an answer to that question, Your Honor. I've
16 been trying.
17 CHIEF JUDGE SLEDGE: Objection
18 sustained.
19 BY MR. STEINTHAL:
20 Q Let me ask you this, sir. I did
21 ask you this question and didn't get an
22 answer.

1 Did you consider anything in the
2 CARP decision on the subject, for example, of
3 agreements entered into after a lawsuit was
4 brought by labels challenging a service for
5 operating outside of a statutory license, in
6 connection with the testimony you gave with
7 respect to this precise issue?
8 A I don't recall anything about this
9 affecting my analysis.
10 Q Well, do you recall in fact that
11 the CARP ruled that agreements entered into
12 under circumstances where labels threaten to
13 sue, or did in fact sue, services for
14 operating outside of the compulsory license,
15 needed to be rejected because of the
16 difference in bargaining power created by
17 virtue of the label's threats or lawsuits?
18 A I don't recall that specific part
19 of the CARP decision. I'd be happy to look at
20 it now. I'd also mention that my testimony
21 says that one of the reasons I rejected the
22 custom radio services is because of the cloud

1 of litigation.

2 Q And is it your testimony the cloud

3 of litigation tends to depress the price that

4 would be paid by a licensee?

5 A The cloud of litigation affects

6 the nature of what is being agreed to. What

7 is being agreed to is not a sort of free

8 market rate, but it is for the two parties

9 expectations of what they expect will be the

10 outcome of the litigation.

11 Q So you wouldn't want to rely on

12 agreements that are entered into under the

13 cloud of litigation?

14 A I would say ¦ as I said, that's

15 the reason I didn't use the customized radio

16 agreements.

17 Is any litigation, is any cloud of

18 litigation a reason not to use an agreement?

19 I'd have to know the specifics, and what the

20 nature of the litigation is.

21 But I think I was pretty clear

22 that uncertainty over whether a customized

1 radio service are inside or outside the
2 statute is manifest also in the litigation,
3 affects what those prices are telling you.
4 Q And is it ever the case that the
5 defendant somehow ends up with more leverage
6 against the plaintiff in a negotiation that
7 occurs after a lawsuit is brought?
8 A It depends on what the lawsuit is
9 relative to what we're talking about.
10 Q That's your testimony?
11 A Yes, that's my testimony.
12 Q Okay.
13 I believe you testified that ¦ and
14 this is a variation on the not too low ¦ we're
15 going with the not too high part of the CARP
16 ruling ¦ I believe part of your testimony was
17 that you believe that the prior CARP rate was
18 not too high, or else you would have expected
19 to observe some deals under the statutory
20 rate; correct?
21 A Yes.
22 Q Are you aware that Yahoo has

1 entered into some direct deals with
2 independent labels including the Orchard?
3 A Yes. I don't know specifically
4 about the Orchard. I don't remember
5 Q Ever heard of the Orchard?
6 A I've seen the label. I don't know
7 much about it.
8 Q Did you take into consideration in
9 connection with any of your testimony the
10 phenomenon or the terms of Yahoo's deals with
11 independent labels?
12 A I didn't.
13 Q Wouldn't you want to take into
14 consideration in assessing the marketplace
15 what voluntary arrangements had been entered
16 into between willing sellers that are members
17 of SoundExchange and Yahoo?
18 A If it's for the statutory service,
19 then I would say it's once again strongly
20 influenced by the existing statutory rate.
21 That's the rate absent the negotiated outcome,
22 so that has a powerful influence on the rate.

1 Q Let me get this right.
2 So in the willing seller-willing
3 buyer market we're supposed to replicate, you
4 don't want to look at deals that are entered
5 into between one of the willing sellers that's
6 a member of SoundExchange, and one of the
7 willing buyers that's operating under the
8 statutory license?
9 A Not at this point in time, given
10 that there is a rate already there in the
11 market.
12 Q Not at this point in time given
13 that there are already rates in the market?
14 A There's already a statutory rate
15 set in the market, so if you want to try to
16 look at a market where there is a government-
17 determined price, and you see that there is
18 some negotiation off of the government-
19 determined price, that's got to be strongly
20 influenced by what that government-determined
21 price was.
22 Q So even if several record labels

1 and several services got together and came
2 before this panel and said, we've entered into
3 a series of deals in the market, you would
4 ignore them in favor of your hypothetical
5 market because you believe they would be
6 affected by the existing statutory rate?
7 A I'd have to know the details of
8 what you are talking about, because it sounds
9 to me you've almost talked about a settlement
10 of the case. In other words, if a number of
11 the parties got together and came in front of
12 the CARP and said, we will agree to a
13 particular rate, that becomes essentially a
14 settlement of the case.
15 Q Is that not a willing buyer-
16 willing seller resolution?
17 A At that point I frankly don't know
18 how I would regard that. I think that is a
19 legal question I don't think I could answer.
20 Q But as an economist you would
21 prefer to do your model based on these
22 interactive benchmark services and making the

1 assumptions and adjustments you do, you would
2 prefer having a rate set based on that than
3 these actual voluntary agreements between
4 people who are within or who are members of
5 SoundExchange, and members of DiMA who are
6 operating under the statutory license;
7 correct?
8 A Because these are a very small
9 part of the market, because if these contracts
10 include uses of the music for something other
11 than statutory service, it adds complexity to
12 this; because it is not the music of 80
13 percent of the industry; I would not prefer to
14 use that, and I did not use it.
15 Q Now your model just assumes that
16 the same considerations apply to
17 nonsubscription statutory license services as
18 subscription statutory license services;
19 correct?
20 A I don't think I used the term,
21 same considerations. I said I'd recommend
22 that the rate be based on the analysis I did,

1 which stemmed from the examination of the
2 subscription services.
3 Q You make no effort to measure the
4 difference in the value proposition to
5 consumers of nonsubscription statutory license
6 webcasting versus subscription statutory
7 license webcasting; correct?
8 A Because I don't think that's the
9 right basis for setting the rate.
10 Q Well, and that's because, if I
11 wrote it down correctly, you feel that the
12 sellers should have the ability to capture the
13 rates that the value consumers would be
14 willing to pay; is that it, roughly?
15 A They should be able to capture the
16 value that consumers place on the music and
17 are willing to pay for the music, rather than
18 have it cannibalized by a different service
19 where, let's say, advertisers ¦ and again,
20 this is at present, advertisers are paying
21 less than consumers do directly.
22 Q Well, let me do it bit by bit if I

1 can.

2 You do concede, do you not, that

3 you sought to identify the value to the

4 consumer in the market for statutory license

5 webcast services; correct?

6 A For the subscription services.

7 Q Just for the subscription

8 services?

9 A I used that as the basis of

10 recommending a rate, and I believe that should

11 be applied across the board.

12 Q And isn't the reason you chose to

13 rely entirely on data from the subscription

14 statutory license webcasters, is that the

15 evidence you wanted to look at to identify the

16 value to the consumer of the statutory license

17 webcast services is the observed price paid by

18 consumers?

19 A I think I agree with that. I need

20 to get the exact wording again, if you don't

21 mind. I'm sorry, it's late.

22 (Question read back.

1 WITNESS: I would say no, it's not
2 the evidence I want to look at. That is the
3 evidence in the market of what consumers value
4 the noninteractive webcast.
5 BY MR. STEINTHAL:
6 Q Well, the only observed prices you
7 had were subscription prices; right?
8 A That's the only direct observation
9 of what ¦ how consumers value those types of
10 webcasts; correct.
11 Q So using Dr. Brynjolfsson's 2005
12 statistics of 90 percent of the webcast
13 activities under the statutory license being
14 nonsubscription, and 10 percent being
15 subscription, it's correct, is it not, that
16 you relied on the observations from the 10
17 percent slice of the market in order to
18 generate your conclusions for the entirety of
19 the market?
20 A Let me first say that 10 percent
21 as subscribers is not 10 percent of the demand
22 for the service. I did rely on it, as we've

1 just said. We ¦ that is where customers value
2 it directly.
3 We don't know what the percentages
4 are going to be over time as far as the
5 relationship between subscription and ad-
6 supported. There is a lot of expectation in
7 the market, including those from Yahoo and
8 other music services that ad-supported is
9 becoming much more popular and a much greater
10 revenue source.
11 I did not try to come up with a
12 separate estimate of how much could be raised
13 from the ad-supported market.
14 And there are, as I said earlier,
15 also services that get the value through a
16 bundled approach. So the answer is, I looked
17 where I saw the data, where I saw a
18 measurement, and I applied that across the
19 board, because that is what I believe the
20 willing seller would do in a free market.
21 Q But again, you went on for some
22 time, the bottom line is, the only prices you

1 observed were the subscription prices, and you
2 then used those subscription prices and
3 extended them across the whole universe of
4 statutory licensed webcasting for your model;
5 correct?
6 A I used those prices. I didn't
7 extend the prices; I extended the rates I got
8 from the prices, either on a per subscriber
9 basis; on a revenue percentage; and on a per
10 play basis, under the assumption of a
11 tremendous number of plays typical of the high
12 end of the subscription services.
13 Q So there is no question in your
14 mind right now that the vast multitude of
15 streaming activity for statutory license
16 webcasters is through nonsubscription
17 services; correct?
18 A I wouldn't agree with that
19 characterization.
20 Q On what do you base any different
21 conclusion?
22 A Well, as I've said, I've looked at

1 the Yahoo numbers. Yahoo is a major service,
2 and I would say possibly the most powerful
3 service in the market, and they have a
4 streaming ratio, as we said earlier, I hate to
5 repeat it, it's confidential, but that's far
6 from being ¦
7 Q I think ¦
8 A -- let me complete this ¦ far from
9 being a vast majority.
10 And the other thing, it's where
11 the money is. If you look at the revenue you
12 get from, let's say, 100 subscribers to the
13 service rather than, at present, what you get
14 from 300 ad supported customers, you're
15 getting much more from the subscription
16 customers, and I don't see why a copyright
17 holder would want to see the profitable part
18 of the market cannibalized.
19 Q Who's talking about the profitable
20 part of the market being cannibalized here?
21 A I think that's what is the
22 eventual result if you set a rate for the

1 market based off of the part of the market
2 where the payment is much less than it is in
3 the subscription market.
4 Q By the way, your ratio for Yahoo
5 it three to one, right?
6 A Yes.
7 Q Seventy five percent of the
8 streaming activity in the way you prefer to
9 look at it is nonsubscription?
10 A Yes, I think that's three to one,
11 75 percent. But if you take the money you get
12 from it, it's more from the 25 percent than
13 you get from the 75 percent.
14 Q Do you have any specific
15 information on which you base that?
16 A Yes.
17 Q That's the Yahoo-produced
18 information?
19 A That's the Yahoo-produced
20 information.
21 Q We'll get a chance to look at
22 that, okay.

1 But let me ask you this. On page
2 55 if you would turn to page 55, do you see
3 where you state on this page that in a free
4 market the owner of the intellectual property,
5 eg. the record companies, could set a fee
6 based on the highest value use of its
7 property, rather than sell at a lower price to
8 an alternative delivery mechanism that would
9 undermine the sales of the higher priced
10 service option.
11 Do you see that?
12 A Yes.
13 Q Is this in part why you believe it
14 is warranted to look at just what consumers
15 are paying for the subscription part of
16 statutory licensed webcasting and not look at
17 nonsubscription webcasting?
18 A This is part of the reason, yes.
19 Q And I gather the highest value use
20 of property you're talking about is the
21 subscription market; correct?
22 A Correct.

1 Q Compared to the nonsubscription
2 market?
3 A That's correct.
4 Q Let me give you this hypothetical,
5 which is going to become familiar. It's the
6 soda-on-the-beach hypothetical.
7 If you're selling sodas on the
8 beach in 90 degree weather, and you'd have to
9 walk a mile into town to get an alternative
10 source of supply for soda, you'd agree, would
11 you not, that the seller in that transaction
12 is able to extract a higher price for the soda
13 than would be the case if we were in the
14 middle of town, right?
15 A The seller could?
16 Q Yes.
17 A It could extract a higher price
18 based on the transport cost to the beach.
19 Q Or based on the buyer's unique
20 circumstances and desire in 90 degree weather
21 on the beach to pay five or even ten times the
22 normal price for that can of soda, right?

1 A Not if the ability to provide soda
2 on the beach is ¦ can be ¦ is in the hands of
3 many different parties or entrants.
4 In other words, you might be the
5 person trying to sell the soda at $5 a can to
6 me on the beach, and I'd be willing to pay $10
7 for it. But if somebody else is willing to
8 lug the soda there, and cans of soda there,
9 and charge less, then that's going to start
10 driving the price down.
11 Q But in the hypothetical where
12 there is one seller, multiple buyers, 90
13 degrees, and a mile to walk, you'd agree that
14 the price you would expect for that can of
15 soda is going to be a heck of a lot higher
16 than it would be if you were buying that same
17 can of soda in town, right?
18 A If you set up a monopoly right,
19 and you have a greater demand, you're going to
20 see a higher price, I agree.
21 Q Would you agree with me that in
22 looking at a fair market value for soda, you

1 would not want to look at just the sliver of
2 the market that would be represented by unique
3 circumstances like a single seller in the soda
4 on the each example that I gave you?
5 A If that was what I was tasked with
6 doing is looking at the soda market. Also,
7 you used the term, a fair price.
8 Q Fair market value.
9 A Well, fair market value, then, the
10 question is, a fair market value for what? If
11 it's for soda on the beach, then you'd use the
12 price that was in that market. If it was soda
13 in general and you wanted to know what the
14 average price of soda sold in the market was,
15 then you would not use that, because that is
16 not the average price of soda sold in the
17 market.
18 Q Now let's go back to the sliver of
19 the market you're looking at in subscription
20 services as opposed to nonsubscription.
21 You view the subscription services
22 as representing the highest value use of the

1 sound records as compared to the use of the
2 sound recording by nonsubscription services,
3 correct?
4 A That's true at present. To the
5 extent we can measure it. There's a lot of
6 nonmeasureable benefits to the nonsubscription
7 services. So throw that into the equation.
8 Q And as we said before, for the
9 reasons you've articulated, you chose not to
10 make any kind of adjustment in your model to
11 account for the fact that most users are not
12 willing at this time to pay for statutory
13 license webcasting; correct?
14 A Right, and I think it's very
15 important that what's paid in the market
16 reflects the current statutory rates. So the
17 statutory rate allows an ad-supported service
18 with relatively limited revenue coming from
19 that to be in the market.
20 Q Now for the reasons you state in
21 your report, you assume that it is appropriate
22 to generalize from the circumstances of the

1 highest valued user to the entire statutory
2 license webcasting market, right?
3 A I think that that is what the
4 willing seller would do if it's setting a
5 single price in all markets.
6 If this soda seller was ¦ had his
7 prices determined by a court, and that's where
8 he could make the money, I would not force him
9 to set a price at the beach that was based on
10 prices off the beach.
11 MR. STEINTHAL: Your Honor, I'm at
12 an appropriate breaking point, and I have not
13 very much more.
14 CHIEF JUDGE SLEDGE: We're reaching
15 a point in cross-examination near the end of
16 the day.
17 We'll recess until 9:30 in the
18 morning.
19 (Whereupon at 4:58 p.m. the
20 hearing in the above-entitled matter was
21 adjourned, to reconvene at 9:30 a.m. the next
22 morning)

CERTIFICATE

This is to certify that the foregoing transcript in the matter of:

The Digital Performance Right in Sound Recording and Ephemeral Recordings (Webcasting Rate Adjustment Proceeding)

Before: Copyright Royalty Board

Date: Monday, May 15, 2006

Place: Washington, D.C.

represents the full and complete proceedings of the aforementioned matter, as reported and reduced to typewriting.

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Before the
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Washington, D.C.

In the matter of:	
The Digital Performance Right in Sound Recordings and Ephemeral Recordings	Docket No. 2005-1 CRB DTRA
(Webcasting Rate Adjustment Proceeding)	

Volume 10

Room LM-414
Library of Congress
First and Independence Ave,, S.E.
Washington, D.C. 20540

Tuesday,
May 16, 2006

The above-entitled matter came on for hearing, pursuant to notice, at 9:30 a.m.

BEFORE:

THE HONORABLE JAMES SLEDGE, Chief Judge
THE HONORABLE WILLIAM J. ROBERTS, JR., Judge
THE HONORABLE STAN WISNIEWSKI, Judge

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I-N-D-E-X

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1 P-R-O-C-E-E-D-I-N-G-S

2 9:35 a.m.

3 CHIEF JUDGE SLEDGE: Good morning.

4 We'll come to order.

5 Mr. Steinthal?

6 MR. STEINTHAL: Thank you, Your

7 Honor.

8 CROSS-EXAMINATION (CONT'D)

9 BY MR. STEINTHAL:

10 Q Good morning, Dr. Pelcovits. How

11 are you?

12 A Good morning, Mr. Steinthal.

13 Q We picked up just for a moment

14 where we left off yesterday on the issue of

15 non-subscription statutory licensed webcasters

16 versus subscription webcasters for a minute.

17 I'd like you to assume, for

18 purposes of my question, that 75 to 90 percent

19 of the universe of unique listeners to

20 statutory licensed webcasting are non-

21 subscription webcasters -- listen to non-

22 subscription webcasters. Okay?

1 And assume as well that a
2 substantial majority of that universe is not
3 and never will be willing to pay for radio.
4 Okay?
5 A Yes.
6 Q Now, you currently make no
7 allowance in your model for the demand
8 represented by those consumers. Correct?
9 A Not explicitly, no.
10 Q And I think you testified
11 yesterday that for purposes of your model, you
12 assumed that all the demand was represented by
13 the higher value users, who are subscription
14 users of statutory licensed webcasting.
15 Correct?
16 A I wouldn't say I assumed it but I
17 calibrated the model and the estimate of value
18 from the subscription customers, yes.
19 Q And not taking into consideration
20 that non-subscription universe. Correct?
21 A I just repeat the answer I just
22 gave you, which is, I calibrated it that way

1 and I think I explained the reasons why I
2 believe it should apply across the board.
3 Q Well, you stated yesterday that
4 one reason that you did not consider non-
5 subscription users was concerns over the non-
6 subscription or low value users cannibalizing
7 the subscription service market. Correct?
8 A Well, other than the word
9 consider. I did consider them but the reason
10 I did not try to -- one of the reasons I did
11 not try to separately value those customers
12 was because of concerns over cannibalization,
13 that's correct.
14 Q Did you do any study or analysis
15 of the extent to which non-subscription web-
16 cast users currently do or would, in the
17 future, cannibalize subscription statutory
18 licensed webcasting?
19 A No, I did not. Let me just add,
20 in order to really to that you'd need sort of
21 an experiment of changing prices for the
22 statutory license and see how the market

1 reacts. So, I didn't.
2 Q Now also yesterday, on your direct
3 testimony in the morning, I believe you
4 testified that, in connection with why you
5 weren't going to make an allowance for non-
6 subscription statutory licensed webcast
7 listeners, you made an analogy to the motion
8 picture market, did you not?
9 A Well again, I don't use the word
10 didn't make an allowance for, but I did make
11 an analogy to the motion picture industry
12 where for purposes of explaining that, there
13 could be a value to using a form of media in
14 an advertiser supported forum that could
15 potentially cannibalize the revenues from a
16 subscription.
17 Q Well it's true, is it not, that
18 movie copyright owners license their content
19 both in theatrical release markets and the
20 advertiser supported free television market.
21 Correct?
22 A They do but not at the same time

1 and it depends on the show. So, yes, they do
2 and they do under their own estimate of how to
3 make profits in their business.
4 Q Wouldn't you agree that any
5 complete economic analysis of the motion
6 picture business would have to take into
7 consideration the various revenue streams of
8 motion pictures, including theatrical release,
9 home video, pay per view, and advertiser
10 supported free TV?
11 A My answer is it depends on what it
12 is that you're analyzing. I would say and, if
13 we're going to draw this analogy, that if the
14 Court here were setting rates for motion
15 picture copyrights and they were to compel the
16 motion picture industry to base its rates for
17 per view off of the advertising paid when a
18 motion picture finally reaches the broadcast
19 TV, they would be under-valuing the value of
20 that copyright.
21 Q But the reality is that in the
22 motion picture industry it's true, is it not,

1 that motion picture copyright owners derive
2 different levels of compensation on a per use
3 or per view basis comparing theatrical release
4 to home video release to advertiser supported
5 television, don't they?
6 A Yes.
7 Q And they get a heck of a lot more
8 in a theatrical release market per view than
9 they do in the advertiser supported free TV
10 market, don't they?
11 A They do and add in a very
12 important part of their revenue stream, which
13 is DVDs.
14 Q And that comes in in the middle.
15 Right? I mean, you pay roughly $4 per view
16 for a DVD compared to $10 per view for a
17 theatrical motion picture. Right?
18 A What's interesting is that they're
19 getting that 50 percent of the ticket price in
20 a movie theater and 50 percent of the price in
21 a DVD rental.
22 Q And the advertiser supported

1 thing, the advertiser supported per view
2 analysis would be a fraction, wouldn't it?
3 A I don't know. I've never seen it
4 expressed as a percentage.
5 Q Now I believe you testified on
6 your direct yesterday, and it's on page 32 of
7 your written testimony as well, you assume for
8 your model, do you not, that the ratio of the
9 consumer price for a subscription music
10 service to the sound recording royalty rate
11 would be the same in both your benchmark
12 market and your target market. Correct?
13 A Yes.
14 Q And that's a key assumption in
15 your analysis?
16 A It is.
17 Q And you base this assumption on
18 your opinion, and this is also on page 32, I
19 believe, that the demand elasticity in both
20 the target market and the benchmark market
21 will be very similar, if not the same.
22 Correct?

1 A Yes.
2 Q And that's based on your
3 comparison, your analysis of the comparison
4 between the benchmark market and the target
5 market. Correct?
6 A It's based on the fact that that
7 these are very similar markets, similar types
8 of consumers and also based on general
9 knowledge of elasticity estimates and pricing
10 practices in a variety of industries.
11 Q But I believe you also testified,
12 based on your conclusion that the supply and
13 demand characteristics in both markets are
14 comparable. Correct?
15 A I didn't say comparable. I think
16 I already just said what I said, which is they
17 have similar buyers and similar sellers.
18 They're very similar markets.
19 Q But there were no differences you
20 identified in that respect that would change
21 your opinion with respect to the elasticity
22 issue. Right?

1 A I felt that it was a reasonable
2 assumption that the elasticities were similar
3 and that they were close enough to apply the
4 same percentage in the two markets. I cannot
5 say they are exactly the same. It could be
6 somewhat higher, it could be somewhat lower.
7 It would yield, in my opinion, a result that
8 would be at or close to the one that I
9 recommend.
10 Q Now your model, looking at page 34
11 of your statement, also assumes, does it not,
12 that any change in the copyright fees can be
13 passed on dollar for dollar to consumers in
14 both the benchmark and the target markets.
15 Correct?
16 A In this model, that's correct.
17 Q And when you're talking about
18 copyright fees, you're talking about the sound
19 recording copyright fees. Correct?
20 A Correct.
21 Q And that's the normal assumption
22 in a competitive market with constant average

1 and marginal costs, is it not?
2 A Yes.
3 Q But as you testified yesterday,
4 you took this market as it is, without any
5 analysis of whether it's a competitive market.
6 Correct?
7 A I used a competitive market model
8 for purposes of estimating and recommending a
9 rate, that's correct.
10 Q Now, did you do any analysis,
11 going back to the question of whether your
12 assumption that in the target market or the
13 benchmark market, the copyright fees could be
14 passed through to consumers dollar by dollar,
15 did you do any analysis of either the target
16 market or the benchmark market to determine in
17 fact whether statutory licensed webcasting
18 services, for example, would be able to pass
19 off, dollar for dollar, increases in sound
20 recording royalty costs?
21 A I studied the industry. I looked
22 at the rapid evolution and entry of many firms

1 into the industry and it's my belief that in
2 an industry where you see entry taking place
3 relatively easily, the competitive model is a
4 reasonable model used.
5 Q Let me pause right there. This
6 notion of rapid entry into the industry, it's
7 true, is it not, sir, that the number of
8 entities engaging in statutory licensed
9 webcasting has shrunk substantially since
10 2001? Is it not?
11 A I don't know if that's true, but I
12 know there are many firms that have entered
13 and built new business models in this industry
14 that are brand new and there seemed, from
15 everything I studied, to be no major barriers
16 to entry.
17 Q Name one entity, sir, that entered
18 the market for statutory licensed webcasting
19 since 2001.
20 A As far as I know, I think Live365
21 is a, if it's not brand new, it's entire
22 breadth and operation in the market has

1 developed significantly in the last few years.
2 I think the entire market has grown quite a
3 lot in the last few years.
4 Q Let's talk about your testimony
5 just this morning --
6 A Right.
7 Q -- about entry into the market.
8 Live365 I will represent to you participated
9 in the CARP in 2001. They've been around for
10 a while. Can you name any entity, any entity,
11 that has come into the market for statutory
12 licensed webcasting since the initial CARP
13 rate was set in 2002?
14 A I think that any broadcaster, any
15 channel, that has come into the market is
16 brand new. Live365 has, and constantly
17 advertises, it has thousands and thousands of
18 channels, many of them brought to the market
19 by very small entities. Anytime you have
20 someone who decides to become a webcaster and
21 use the Live365 platform, they are a new
22 entrant into the market. They are providing

1 the music to customers. There is, the same
2 thing is true of the thousands of channels
3 that are being broadcast to the Rhapsody
4 customers on Radio Pass. Radio Pass has, I
5 believe, over 3,000 channels.
6 So, I believe any time there is a
7 new webcaster, regardless of exactly the
8 mechanism by which the webcaster delivers a
9 service to the customer, that is entry.
10 Q Sir, are you suggesting that an
11 individual hobbyist that pays $10 a month to
12 Live365 or whatever it is, to get its signal
13 delivered through Live365 is comparable in
14 circumstances to the statutory licensed
15 circumstances of AOL or Microsoft or Yahoo?
16 A It is an entrant that leads to the
17 disciplining of prices. And it's the
18 disciplining of prices that's the hallmark of
19 a competitive model. In other words, if there
20 is an inferior product or too high priced a
21 product, then other people can come in and
22 provide the music. It is very easy to lease

1 capacity band width from Live365 and get on
2 the air. And if you do that, --
3 Q Sir --
4 A -- I'm sorry, let me complete my
5 answer. And if you do that, in my mind,
6 you're an entrant into this market. You can
7 be a webcaster. There are many radio stations
8 that are coming online all the time. They are
9 being rebroadcast through subscription
10 channels. So, in my mind, that is and does
11 constitute competitive entry.
12 Q Now could you answer my question?
13 Do you view an individual hobbyist who puts
14 his channel up on Live365 as comparable in
15 circumstance economically to AOL, Yahoo, or
16 Microsoft operating their statutory licensed
17 webcasting operations under this license?
18 A They are no comparable. They are
19 a competitive factor and they are there to
20 discipline the market.
21 Q And how do they discipline the
22 market for the licensing of sound recording

1 performance rights under the compulsory
2 license when they don't pay the sound
3 recording compulsory license fees?
4 A I'm talking about competition in
5 the market for the delivery and the
6 copyrighted music to the customer, not in
7 terms of the SoundExchange copyright fee.
8 That's set by the -- was set by the CARP, will
9 be set by this Court.
10 Q Are you familiar with the fact
11 that the individual broadcasters or hobbyists
12 whose channels are aggregated by Live365 don't
13 pay the sound recording royalty Live365 does?
14 A They pay to Live365 fees that
15 Live365 then pays to SoundExchange.
16 Q So the answer is yes, you are
17 familiar with the fact that they don't worry
18 about paying the sound recording royalty fee,
19 they look at what the Live365 fee is to them
20 for getting their channel up. Right?
21 A That doesn't mean they don't worry
22 about what the rate is because the rate flows

1 through to what they have to pay and that then
2 affects the behavior of competition in the
3 marketplace. It doesn't matter who, whether
4 there's an intermediary that you write the
5 check to, there's still competition in the
6 marketplace.
7 Q Let's go back to your testimony
8 just this morning, under oath, about the rapid
9 entry into the market. You've cited
10 individual hobbyists or broadcasters that get
11 their channels up on Live365. Can you name
12 one other company since 2001 that ha launched
13 and entered into the statutory licensed
14 webcasting market?
15 A My regression had a list of 30
16 services. Do I -- they included Radio IO,
17 Digital Imported, GotRadio, 3WK, Ultimate 80s,
18 Cross Walk, WOLF FM, Howling Oldies and Super
19 70s. Do I know when they actually entered the
20 market? No.
21 Q And even if you knew that they had
22 entered the market before or after, would you

1 compare any of the economic circumstances of
2 those entities that you just mentioned, to
3 AOL, Yahoo, or Microsoft?
4 A They are different companies.
5 They are going to be different. That doesn't
6 mean there are not competitive factors in the
7 market.
8 Q Just so it's clear, even though
9 you've testified that there's been rapid entry
10 into the market, you can't identify as a
11 matter of fact that has entered the market
12 under the prior CARP rate. Correct?
13 MR. HANDZO: Objection. That
14 misstates his testimony.
15 CHIEF JUDGE SLEDGE: Sustained.
16 BY MR. STEINTHAL:
17 Q Can you identify anybody, as a
18 matter of fact?
19 MR. HANDZO: Objection. Asked and
20 answered.
21 CHIEF JUDGE SLEDGE: I assume the
22 question is other than the ones you've already

1 identified?

2 MR. STEINTHAL: Other -- yes.

3 BY MR. STEINTHAL:

4 Q Other than the ones you've already

5 identified? Fair enough.

6 A Can I identify when they've

7 entered? No. There has been quite a lot of

8 firms entering into this market, which is a

9 very new market.

10 Q And on what do you base your

11 testimony that quite a lot of firms have been

12 entering the market?

13 A On my list of firms and research

14 that was done on who is in the market, how

15 many are in the market, and my knowledge that

16 this business as a whole, as a subscription

17 business, has been developing very rapidly

18 over the last several years. It's essentially

19 something that's discussed in virtually

20 anything you read about the industry.

21 Q When you say subscription

22 business, are you talking about your target

1 market, your benchmark market or both?
2 A I was talking about the target
3 market. That's what the -- in order to sort
4 of apply this competitive model, I'm assuming
5 that this is the case in both markets.
6 Q And about this rapid entry. Are
7 you familiar with the filings in the copyright
8 office indicating the number of entities that
9 are making, excuse me, the number of entities
10 that are availing themselves of the statutory
11 license under Section 114?
12 A I don't know of the filings. I do
13 know who has paid SoundExchange.
14 Q Well, are you familiar with the
15 fact that if you look at the number of
16 entities actually availing themselves of a
17 Section 114 compulsory license, that number
18 has dropped precipitously since 2001?
19 A I don't know that it would not be
20 consistent with what I've seen from who is
21 paying SoundExchange in the last three years.
22 I don't know about 2001. In my mind, that's

1 very, that's ancient history in this business,
2 given the rapid development. So, I think the
3 fact that there have been a large number of
4 firms, a large number of active firms, no
5 obvious barriers to entry, says in my mind,
6 that it's reasonable to model this as a
7 competitive industry.
8 JUDGE WISNIEWSKI: Excuse me, just
9 for a second. Could you identify for the
10 record where you were reading from in terms of
11 the list of firms used in your regression?
12 THE WITNESS: Yes, Judge. This is
13 just a list, a table that I constructed of the
14 non-interactive services used in the
15 regression, so it's among the different
16 documents that we've prepared and provided in
17 the case. I don't believe --
18 JUDGE WISNIEWSKI: Is there a tab
19 that it was --
20 THE WITNESS: This is not part of
21 the testimony.
22 JUDGE WISNIEWSKI: Oh, okay.

1 Sorry.

2 MR. STEINTHAL: I actually was

3 going to mark it as an exhibit shortly, Your

4 Honor, so you can see it.

5 JUDGE WISNIEWSKI: Oh, okay.

6 Thank you.

7 BY MR. STEINTHAL:

8 Q Now again, on the subject of the

9 ability to pass along any increase in the

10 royalty rate, dollar for dollar, to the

11 consumer, you testified that, you know, what

12 you did or didn't do with respect to that

13 conclusion. Are you familiar with the fact

14 that the online music industry still faces

15 competition in terms of consumers from free

16 services, such as Kazaa, and eDunky, and other

17 file sharing services?

18 A I would say that there might be

19 some competition for how the consumer spends

20 his or her dollar on music, as a whole, but

21 those are services which, as you said, are

22 file transfers. So, they become downloads and

1 illegal downloads.
2 Q Well, you're familiar with the
3 fact that a lot of activity goes on by users
4 using those services in obtaining music, are
5 you not?
6 A Absolutely. There is still a lot
7 of piracy taking place. I agree with that.
8 Q Did you take into consideration in
9 your assumption that digital music services
10 could pass along, dollar for dollar, increases
11 in sound recording royalties, the competitive
12 impact in pricing by virtue of the existence
13 of those services?
14 A I think yes. I think I took
15 account of that. That's exactly the nature
16 of, when I talk about a competitive model,
17 the availability of substitute, the legal or
18 illegal effect, what the demand curve looks
19 like, they don't affect the general behavior
20 of firms in a competitive market. It's -- let
21 me just explain something.
22 You were trying to say that

1 competition means you can't pass all of your
2 costs along. Competition is what requires
3 firms and forces firms to essentially price
4 based on cost. And as cost changes, price
5 changes.
6 Q But sir, you assumed, you said it
7 this morning, that in your target market and
8 in your benchmark market, any increase in the
9 sound recording royalty cost could be passed
10 along, dollar for dollar, to the consumer.
11 Right? Are you with me so far?
12 A I said that that's the way in
13 which I analytically structured the model.
14 Yes, I used a competitive industry model.
15 Correct.
16 Q Now, what I'm asking you is
17 whether, in making that assumption, it's a
18 valid assumption if in fact, because of the
19 existence of these free services, digital
20 music companies don't feel as if they can pass
21 on all their costs, dollar for dollar, to the
22 consumer?

1 A That's an absolutely valid
2 assumption. What you're talking about is how
3 much demand will change if costs are passed
4 along. You're also talking about some things
5 which would affect market equilibrium in the
6 shorter run, rather than what happens when an
7 industry shakes and the affects of costs
8 changes alter the nature and the type of
9 things being provided. But cost increases get
10 passed along in a competitive industry, cost
11 decreases get passed along in a competitive
12 industry. These are not perfect models
13 because there's a lot of complexity but as a
14 working hypothesis and a working model, I
15 modeled this as a competitive market. I also
16 modeled it and experimented with this as a
17 oligopolistic model. And it's a ver complex
18 set of models, but it would not change my
19 underlying conclusions.
20 Q Well, let me ask you this. Did
21 you consider whether some of the prices that
22 are currently being offered in your benchmark

1 market are lower than they ultimately will be
2 because firms are deliberately pricing their
3 products at a low price point to try to build
4 demand for those new music services precisely
5 to compete with the free Kazaas and the
6 eDunkys and the Groksters?
7 A They might be doing that just as
8 the target market companies might be doing
9 that. And there is certainly a lot of market
10 building that's going on. But in terms of
11 what prices are now indicating something to us
12 about consumer value in the market, the prices
13 are what they are.
14 Q But hypothetically, if in fact
15 your benchmark market companies are pricing
16 deliberately at a price point lower than what
17 they expect the price to be to build demand
18 for the product at a time when there are still
19 free services offering file sharing, you'd
20 agree with me, wouldn't you, that if the price
21 in your benchmark market is under what it
22 economically normally would be, then your

1 model doesn't capture that difference between
2 the current under-market price and what the
3 market price ultimately will be. Right?
4 A It doesn't capture it. I don't
5 know what that does to the application of the
6 benchmark. That would depend on a lot of
7 different factors. I, frankly, haven't worked
8 through all of them.
9 Q So you didn't -- let me ask you
10 this. Hypothetically, if in fact companies
11 engaged in your benchmark market have done a
12 short-term price campaign to build demand and
13 a year from now the prices in your benchmark
14 market were 50 percent higher than they
15 currently are as they settle in in a corrected
16 mode, then you would have a different result
17 from your model. Right?
18 A We'd have a different result from
19 both the standpoint of the music service and
20 from the standpoint of the music companies.
21 The -- if we look at the percent of revenue
22 fee charged in my benchmark market, that's

1 tended to stay in the same range, 40 to 50
2 percent, for quite a long time, and it's
3 applied to services that have a range of
4 different retail prices, though it seems to me
5 as if the basic conclusion that the copyright
6 fees in that range of percent of revenue seems
7 to be pretty robust.
8 Q Let me put up one of these charts,
9 so I can make this question a little bit more
10 precise.
11 For instance, SoundExchange's demo
12 52. And you calculate, and we'll come back to
13 this in a little bit, but you calculate the
14 difference between what you call the target
15 market, non-interactive webcaster, and the
16 benchmark market, interactive service, and
17 that's the line three on each of your four
18 examples. Right?
19 A Yes.
20 Q So, if it turns out that the
21 pricing in the benchmark market is
22 deliberately at a under-market number now to

1 build demand, and that in fact the market
2 price, once it settles, for example 150
3 percent or 200 percent of the numbers you have
4 in your line two, then the ratio is going to
5 shrink. Correct?
6 A The ratio would shrink, assuming
7 that the same type of thing is not going on in
8 the target market, there is not the same
9 effort by the same type of companies to build
10 their business in those markets.
11 Q Now I believe you relied, in your
12 testimony, on the elasticity of demand
13 assumption that I asked you about a few
14 moments ago, on an article by Alexander
15 Belinfante. Right?
16 A That is the article that I relied
17 on, but not for that assumption.
18 Q What did you rely on it for?
19 A I relied on it as one of the
20 things, one of the pieces of evidence that the
21 demand elasticity for an individual CD is very
22 low.

1 Q Okay. And that study related to
2 demand elasticity as between individual CDs
3 not as between online music services.
4 Correct?
5 A Between or for online music
6 service, yes.
7 Q Indeed, the study was conducted in
8 1977, was it not?
9 A The study was conducted in 1977.
10 It's the only article that I am aware of and
11 I talked to Dr. Belinfante, that he's aware
12 of, that's conducted such an estimate.
13 Q Let me ask you to take a look at
14 Services Exhibit 60. It's the Belinfante
15 article.
16 And can you identify this as the Belinfante
17 article upon which you relied?
18 A Upon which I relied? Yes.
19 (Whereupon, the document
20 referred to as Services
21 Exhibit No. 60 was marked
22 for identification.)

1 MR. STEINTHAL: I would offer
2 Services Exhibit 60 into evidence.
3 CHIEF JUDGE SLEDGE: Any objection
4 to the Exhibit?
5 MR. HANDZO: No objection.
6 CHIEF JUDGE SLEDGE: Without
7 objection, Exhibit 60 is admitted.
8 (Whereupon, the document
9 marked as Services
10 Exhibit No. 60 for
11 identification was
12 received into evidence.)
13 BY MR. STEINTHAL:
14 Q Take a look, if you would, at
15 page, the third page of the document. That
16 would be page 59, if you look in the upper
17 left-hand corner of the book or periodical
18 from which it was obtained.
19 A Now, there's a 49. There's a
20 third sheet, the upper left-hand corner shows
21 a 50.
22 Q All right. I thought it was 59.

1 50, okay. It's my eyes. Sorry. Only my
2 eyes. It's the first thing to go.
3 A There's a paragraph on the bottom
4 left of this page. It reads, as expected, the
5 variable introduced to measure taste, QS,
6 proved to be the most significant one in the
7 model, as is shown by its T value. This also
8 indicates the importance of the use of singles
9 as a way of promoting the sales of an album.
10 The second most significant variable was RC,
11 revealing the importance of radio play and
12 live concerts in giving exposure to a record.
13 Do you have any reason to dispute
14 the validity of that finding?
15 A Not for the purposes and
16 interpretation of the equation as given by the
17 authors.
18 Q By the way when you testified
19 earlier that your regression analysis had a 90
20 some-odd percent confidence level, that
21 assumes your inputs and assumptions underlying
22 the model are correct. Is it not?

1 A It assumes that the -- yes, it
2 assumes quite that it's a meaningful
3 regression and that the data is accurate and
4 I've captured and specified the
5 equation properly. I agree.
6 Q All right. Let's go to the
7 regression, if we can. Let's take a look at
8 the document that you're referring to and see
9 whether I've got the right document. Copy for
10 the bench so they can see it.
11 Marked as Services Exhibit 61 is a
12 document bearing Bate-stamped number SX113974
13 through 113978.
14 Is this the document you referred
15 to earlier as the document containing the
16 inputs in your regression analysis?
17 A Yes, it is.
18 (Whereupon, the document
19 referred to as Services
20 Exhibit No. 61 was
21 marked
22 for identification.)

1 BY MR. STEINTHAL:
2 Q Now, turn to the first page, if
3 you would. The first couple of pages
4 represent the universe of services you looked
5 at in conducting your regression. Is that
6 right?
7 A They are the inputs. Those are
8 the universe, the population, yes.
9 Q And this represented the
10 subscription services that were broadly
11 available for purposes of your regression
12 analysis. Correct?
13 A Yes.
14 Q First of all, I want to make sure
15 we understand each other when we talk about
16 what is statutory licensed webcasting service
17 for purposes of your target market and what
18 isn't.
19 In your written testimony on pages
20 7 to 8 you said, in reference to what is non-
21 interactive webcasting in your target market,
22 --

1 A Right.
2 Q -- you state at the very bottom of
3 page 7, for purposes of this analysis, I have
4 presumed that non-interactive webcasting does
5 not permit any form of user input to customize
6 particular stations. Correct?
7 A Right.
8 Q So I gather, if a station or a
9 service was delivering internet radio that
10 incorporated artist preferences, you would
11 keep that out of your target market analysis?
12 A Well the target market means the
13 market that is eligible for the statutory
14 license. So, it would not be eligible for a
15 statutory license. It does not mean it would
16 not be in the regression. The regression
17 includes all subscription music services,
18 whether they're in or outside of the statutory
19 license.
20 Q Okay. But when you do your
21 comparison of values of target market
22 statutory licensed webcasters to interactive,

1 you would want to make sure that you were
2 comparing statutory license compliance
3 services to benchmark market services.
4 Correct?
5 A Ideally, I would. But I did
6 include in the regression some that are not
7 purely non-interactive. That would be true of
8 Launchcast Plus.
9 Q Well, let's take the ones right up
10 there on your 6.2. Launchcast Plus, you would
11 acknowledge, would you not, is deemed by the
12 recording industry to be not in compliance
13 with the statutory license. Right?
14 A Correct.
15 Q So, if you look at that $3.99
16 figure that you use for purposes of the ration
17 in your modeling, that $3.99 actually
18 overstates to some degree the value of a
19 statutory license service. Correct?
20 A Well, to some degree that I could
21 not measure, yes, I agree.
22 Q Now, Musicmatch Gold, do you know

1 how that service works?
2 A That also, I believe, has some
3 non-statutory features.
4 Q So again, that $4.95 includes some
5 measure of value outside of the statutory
6 license that you were unable to measure.
7 Correct?
8 A Yes.
9 Q And Rhapsody Radio, isn't that a
10 service which enables you to put up to ten
11 artists into your desired preference streams
12 before you get into your stations?
13 A That I wasn't sure of. I had --
14 my understanding was that Rhapsody Radio was
15 a statutory service.
16 Q Well, can you tell us what in fact
17 the features of Rhapsody Radio are?
18 A The features are primarily, it's a
19 streaming, you know, a streaming service
20 similar to many other non-interactive services
21 in their basic characteristics, which is a
22 programed set of music that's delivered to the

1 customer.
2 Q Well, do you know whether it has
3 skipping, for example?
4 A I believe it might, which I think
5 is sort of a controversial issue on which side
6 of the line skipping is. Is it non-
7 interactive or not? I understand that to be
8 an issue that is still not resolved.
9 Q Is it fair to say that as you sit
10 here today, you don't know whether Rhapsody
11 Radio includes certain consumer influence
12 features that the recording industry believes
13 can render it outside the statutory license?
14 A I don't recall.
15 Q All right, let's go to your --
16 Exhibit 61.
17 A Oh, okay.
18 Q Live365 VIP, that one's got the
19 big 10,000 station input factor. Those are
20 the -- that's because it's an aggregator. Is
21 that right?
22 A It is a service that provides more

1 than 10,000 stations. It's actually more than
2 10,000.
3 Q But it doesn't program them
4 themselves, it basically aggregates. I mean,
5 the vast majority of those 10,000 are
6 individual broadcasters or hobbyists whose
7 streams are aggregated and then delivered by
8 Live365. Correct?
9 A Yes.
10 Q Now, the entity here at 19 and 20,
11 DI Gold and DI Platinum, --
12 A Yes.
13 Q -- do you know what that stands
14 for, what the real name of the service is?
15 A I believe it's Digital
16 Interactive, but I don't --
17 Q Digitally Imported ring a bell?
18 A Oh, I think it does. Let me --
19 Digitally Imported, yes. Sorry.
20 Q Did you know that the price for
21 their subscription service, since the time you
22 did your regression analysis, has been dropped

1 to $4.95 a month?
2 A I didn't. That actually would
3 improve my regression results.
4 Q Well, it would ultimately result
5 in lowering the average, would it not, of the
6 non-subscription services and thus increasing
7 the disparity between non-interactive services
8 -- I think I misspoke with the word non-
9 subscription. Let me rephrase it.
10 It's true, is it not that if price
11 was dropped to $4.95, it would increase the
12 ratio between non-interactive services that
13 are under the statutory license and your
14 target market -- I mean, I'm sorry, and your
15 benchmark market. Correct?
16 A It might change the ratio, but
17 that doesn't tell you what the regression
18 would do. I ran regressions without Digitally
19 Imported, without some of the sort of small
20 services. And, in fact, if you look at -- I'd
21 have to check exactly what was in and outside
22 of this in the last page of the exhibit you

1 gave me.
2 That is a regression where I
3 dropped eight of the observations from the
4 sample. Let's see it says -- sorry -- seven
5 of the observations from the sample. You can
6 tell that by seeing under sort of the top of
7 the page, it says, there's a column that says
8 source and then there's DF. DF is degrees of
9 freedom and the degrees of freedom have fallen
10 here, so that means there are fewer
11 observations that are being used in the
12 regression.
13 And when I pull out some of the
14 smaller services, if you look farther down
15 under the regression results where the table
16 that says parameter estimates under the
17 variable for on-demand, the parameter estimate
18 is 0.55 and the one from the regression I use
19 in the testimony is 0.60. So, 0.55 says that
20 the interactive services are worth 55 percent
21 more, rather than 60 percent more.
22 Q Now, you didn't wait --

1 CHIEF JUDGE SLEDGE: Mr.
2 Steinthal, let me interrupt you just a minute.
3 Ten minutes ago, when you
4 testified about the passing along the cost to
5 the consumers and then you went into the same
6 question that has just been asked about the
7 affect of subscription prices to the ratio, I
8 got a little puzzled then and your last
9 question increased my confusion. So, let me
10 just see if I'm straightened out.
11 If the subscription price goes up,
12 what does that do to the ratio?
13 THE WITNESS: To the ratio of the
14 fee to price of the service, sir, Your Honor?
15 CHIEF JUDGE SLEDGE: Yes, this
16 ratio.
17 THE WITNESS: That would depend on
18 whether it's a statutory or non-statutory
19 service. If it's a statutory service, the fee
20 ratio would go down as the price goes up. If
21 it's a non-statutory service and there's a
22 percentage of revenue as part of the contract

1 and that is what governs what is paid, then it
2 would stay the same.
3 CHIEF JUDGE SLEDGE: And if the
4 ratio goes down, your recommended rate in your
5 model goes down?
6 THE WITNESS: The ratio goes down
7 in the benchmark market and that would be the
8 -- and that indeed is what was reflected in
9 the market and that is indeed what the overall
10 evidence would say. Yes, it would.
11 CHIEF JUDGE SLEDGE: Thank you.
12 BY MR. STEINTHAL:
13 Q Sir, in doing your regression, and
14 taking in the data from the companies listed
15 on Exhibit 61, you didn't weight the services
16 by any measure such as how frequently users
17 actually used one service against the other.
18 Correct?
19 A In the regression, I did not. But
20 I say that with respect to the overall result,
21 it doesn't seem to matter.
22 Q And if you turn to the flip side

1 of the first page, the second page, --
2 A We're on?
3 Q -- of your regression?
4 A The second page, sir?
5 Q Yes.
6 A Okay.
7 Q You included XM Radio Online. Is
8 that the satellite radio service that offers
9 several of its stations in an online
10 webcasting format?
11 A That's correct.
12 Q Now, let's see. On 6.2, we talked
13 about the issue with respect to Yahoos, Music
14 Matches, and Rhapsodies radio products. Let
15 me ask you about Radio Free Virgin and Virgin
16 Digital.
17 Are you familiar with the fact
18 that Virgin Digital is a product that is
19 primarily marketed in the UK and not in the
20 US?
21 A It is available if you -- it's
22 available in the US. That part -- that's what

1 I based this on. This is a service available
2 in the US. I don't know where else and how
3 it's marketed and I did not try to measure
4 where the marketing efforts are.
5 Q Would it surprise you to know that
6 there are less than 1,000 or approximately
7 1,000 Virgin Digital US subscribers?
8 A No.
9 Q Now, in doing your comparative
10 analysis to get the ratios that you used for
11 your model, you used the non-interactive
12 services as against the non-portable
13 interactive services. Right?
14 A Correct.
15 Q Now, are you familiar with the
16 fact, sir, that under the statutory license,
17 webcasters operating under the statutory
18 license can deliver their services and it
19 doesn't matter whether the consumer accesses
20 those streams on their computers or portable
21 devices that may be internet enabled?
22 A Yes.

1 Q And they pay the same rate, either
2 way. Correct?
3 A Yes.
4 Q Now, wouldn't it be more apples
5 and apples for purposes of calculating your
6 line three ratios to look at the prices for
7 the non-interactive statutory webcasters which
8 are able to deliver to portable devices as
9 compared to subscription interactive on-demand
10 services that are also able to deliver to
11 portable devices?
12 A If I wanted to, which I didn't,
13 come up with a rate that I said should apply
14 to both portable and non-portable as a
15 recommendation for a statutory rate, then I'd
16 want to use a blend of the portable and non-
17 portable services. I -- so, I think this is
18 a two-step process, rather than your question
19 implying I should have put them all together.
20 Q And if you had looked either at a
21 blended price for portable and non-portable or
22 just the portable interactive services, then

1 the ration would increase, wouldn't it?
2 A The ratio?
3 Q The line three ratio on 6.2?
4 A The ratio would decrease.
5 Q I'm sorry, the ratio would
6 decrease. You'd go from one to two, to one to
7 three, or one to four. Something like that,
8 right?
9 A Something like that.
10 Q And you actually have some of the
11 monthly prices for the portable services in
12 your other report. It's anywhere from $11.99
13 to $14.99, isn't it?
14 A I would, I would -- yes, I have
15 them. I could have done it that way. I could
16 have gotten a lower ratio there. I could have
17 then applied it to a larger consumer price and
18 also to then applied it to the rates being
19 paid by the, in the interactive contracts for
20 the portable services. So, all of the ratios
21 and all of the numbers would have been
22 different. This would have gone down. It

1 would have been applied to a larger number,
2 and that then would have been applied to a
3 larger number. And the number would have been
4 larger.
5 Q Sir, as I'm looking at attachment
6 Appendix 80, a written report, which is the 17
7 contracts that you used to calculate the
8 benchmark market subscription rate, --
9 A Right.
10 Q -- I just want to be sure I'm
11 getting this right. There are 5 of the 17
12 agreements upon which you rely go back to
13 2002, do they not?
14 A Yes. Let me just double check.
15 One, two, three, four -- one, two, three,
16 four, five. Yes.
17 Q And since the exhibit itself
18 doesn't show it -- hold on a second.
19 It's true, is it not, that if you
20 stratify the 17 agreements by entity that
21 actually negotiated with and entered into
22 licenses with the labels underlying this

1 appendix, if I do my math right, four are
2 MusicNet. Correct?
3 A One, two, three, -- one, two,
4 three -- yes.
5 Q And four are Musicmatch before it
6 was acquired by Yahoo?
7 A I'm not sure about the contract
8 from 10/15/04. I think the acquisition, the
9 close of the acquisition was in that month.
10 So, it could be right before or right after.
11 Q And the others are definitely
12 before?
13 A The others are before the
14 acquisition. I'm not sure if they're before
15 the announcement of the acquisition.
16 Q And four from Napster LLC?
17 A Four from -- one, two, three --
18 four from Napster, correct.
19 Q Two from Real Networks?
20 A Two from Real -- Rhapsody Real
21 Networks, yes.
22 Q And three from MusicNow. Correct?

1 A One, two, three from MusicNow. Or
2 did we say four? I didn't --
3 Q I said three from MusicNow.
4 A Okay. I got three. I was going
5 to have to go back if you said four.
6 Q And that was MusicNow before it
7 was acquired by AOL very recently. Correct?
8 A I believe so. I believe that's
9 correct, yes. The acquisition is --
10 Q Sir, turning to a different
11 subject, substitution and promotion for a
12 minute. Okay?
13 On page 51 of your statement, you
14 testify, do you not, that you have found no
15 empirical support for either position, meaning
16 the proposition that statutory licensed
17 webcasting is promotional of sound recording
18 sales or that it substitutes for sound
19 recording sales. Is that a fair statement?
20 A Again, this is all with respect to
21 the relative substitutability of non-
22 interactive and interactive. But that's what

1 I said with respect to that relationship.
2 Q Well, it's true that you found no
3 empirical support for the proposition that
4 statutory licensed webcasting substitutes for
5 sound recording sales. Correct?
6 A No. I said it provided no
7 empirical support that one was more than the
8 other. If you look at the beginning of the
9 paragraph, it says I have seen no evidence to
10 suggest there is any difference between these
11 two markets with respect to their promotional
12 or substitutional effects.
13 Q Well, did you find any empirical
14 evidence that in fact statutory licensed
15 webcasting substitutes for sound recording
16 sales?
17 A I did not.
18 Q And you looked for it, didn't you?
19 A I looked for evidence on
20 substitution in general. I didn't find any
21 measurements of substitution effects. In
22 particular, as I said, and the point I make in

1 my testimony which is what's relevant for my
2 modeling is whether there's a difference in
3 the substitution effects for the bench --
4 between the benchmark and the target market.
5 Q But you were looking for it in
6 both ways. You were looking for it and found
7 no empirical evidence of substitution.
8 Correct?
9 A I was looking something that would
10 let me compare the substitution effects in the
11 benchmark and the target markets. I found
12 nothing that would allow me to measure that
13 difference.
14 Q And you found nothing, just to be
15 precise, that enabled you to measure what
16 extent, if at all, statutory licensed
17 webcasting is in fact substitutional sound
18 recording sales. Correct?
19 A Nothing that would let me measure
20 it. That's correct.
21 Q Now, you testified yesterday that
22 your research materials included Arbitron

1 publications. Correct?
2 A Yes.
3 Q Let mark this as Services Exhibit
4 62, Arbitron Report entitled "Internet 9 The
5 Media and Entertainment World of Online
6 Consumers."
7 Is this, one of the Arbitron
8 reports of the nature that you reviewed in
9 connection with your research?
10 A Yes.
11 (Whereupon, the document
12 referred to as Services
13 Exhibit No. 62 was
14 marked
15 for identification.)
16 MR. STEINTHAL: I offer Exhibit 62
17 into evidence.
18 CHIEF JUDGE SLEDGE: Any objection
19 to Exhibit 62?
20 MR. HANDZO: Well, I would ask for
21 a further foundation. Mr. Steinthal asked
22 whether it was of the nature that he reviewed.

1 I would want tot know whether this is one that
2 he reviewed before we go any further.
3 CHIEF JUDGE SLEDGE: Mr.
4 Steinthal?
5 BY MR. STEINTHAL:
6 Q Do you know whether this was or
7 wasn't one of the ones you reviewed?
8 A I believe it was, there were
9 several years worth of this study. So, I
10 believe I looked at this one. I might have
11 focused on the more recent ones. But I can't
12 say for 100 percent sure I looked at his
13 particular one. I looked at several of this
14 titled report of different vintages.
15 MR. HANDZO: No objection.
16 CHIEF JUDGE SLEDGE: Without
17 objection, Exhibit 62 is admitted.
18 (Whereupon, the document
19 marked as Services
20 Exhibit No. 62 for
21 identification was
22 received into evidence.)

1 BY MR. STEINTHAL:
2 Q On the second page of the
3 document, --
4 A Is that including the cover page
5 or not?
6 Q Yes. The overview.
7 A Okay.
8 Q It says welcome to the Ninth
9 Arbitron Edison Media Research Study of
10 Consumers Use of Streaming Media and the
11 Internet with brand new data from interviews
12 conducted in July 2002. We have conducted
13 these studies every six months since August of
14 1998 and our semi-annual reports have become
15 widely used sources of information on
16 streaming media and consumer behavior on the
17 internet. Is that consistent with your
18 understanding of how the Arbitron reports are
19 generally used in the industry?
20 A In terms of how they're used, it
21 says they are widely used. It doesn't tell
22 you how they're used. And I don't think

1 Aribtron would know, necessarily what everyone
2 uses them for.
3 Q But they are widely distributed
4 and used, to your knowledge?
5 A To my knowledge, they are.
6 Q Take a look, if you would, at page
7 14, paragraph 25. People who stream
8 frequently buy significantly more CDs than
9 most Americans. Some have mistakenly equated
10 the rise of streaming audio with a decrease in
11 record purchases. However, the data show that
12 the more streamees (those streaming in the
13 last month and last week) were also the group
14 that purchased the greatest number of CDs in
15 the past year. The average American purchased
16 13 CDs in the past year, while those that have
17 ever streamed have purchased 15 CDs. Monthly
18 streamees report that they bought an average
19 18 CDs and weekly streamees say they have
20 purchased nearly 21 CDs in the past year.
21 Did you make any reference to this
22 particular finding in the Arbitron reports in

1 connection with your research?
2 A I did review this and I think
3 there's a later one that gives somewhat
4 different data. But I did look at this. I
5 did take account of it. And I can tell you
6 why it does not tell me anything that I could
7 use to quantify what I want to quantify. And
8 there are two reasons for that. One is, it
9 says streamees. It's not clear whether this
10 is interactive or non-interactive streamees.
11 There was nothing in the report that let me
12 come to a conclusion on that. So, it doesn't
13 help at all.
14 Secondly, even to the extent a
15 report would survey customers who are
16 streamees of a particular type and compare
17 them to other customers. It does not tell you
18 -- those can be two different types of
19 customers.
20 Suppose it were true that, just to
21 take an example, high income people buy more
22 CDs and it's also true that high income people

1 tend to be streamees. Then all you've found
2 is the correlation between the two, you
3 haven't found the fact that streaming is what
4 itself leads to more or fewer purchases of
5 CDs.
6 Q Sir, this report was done in 2002.
7 Right?
8 A Yes.
9 Q Do you know how many, if any, of
10 your benchmark market services were actually
11 operating in 2002?
12 A I don't know.
13 Q Would it surprise you to know that
14 the earliest licenses that were secured were
15 in 2001 and then in 2002? And that these
16 services didn't launch commercially available
17 interactive streaming and on-demand services
18 until after the Arbitron report?
19 A I didn't know that.
20 Q Would that affect the conclusion?
21 A That would affect the issue of
22 whether this report could be used to just deal

1 with streamees. I would still be very
2 hesitant to draw any conclusion about
3 different types of streamees, whether they're
4 interactive or non-interactive based on a 2002
5 report.
6 And, finally, and I can say this
7 again very firmly, it is very important when
8 you're doing surveys to try to evaluate
9 things, that you don't mistake correlation
10 with causation. If you just ask a certain set
11 of people are you of this type and do you do
12 more of this? That tells you nothing about
13 the influence of the two behaviors you see of
14 one each other.
15 Q At the end of the day, though, you
16 don't have any reason to dispute the finding
17 here, you just don't know the specific
18 underlying data points. Correct?
19 A Well, the finding is that people
20 that stream more, that the streamers buy more
21 CDs. That is not a finding that people that
22 streaming leads to greater CD purchases. It

1 doesn't tell you whether they bought more CDs
2 before they were streamers or fewer CDs before
3 they were streamers. It doesn't relate the
4 streaming to increased purchases of CDs. It
5 just relates it to people that happen to buy
6 more CDs.
7 Q It doesn't suggest that people who
8 are streaming are not buying as many CDs as
9 they used to, does it?
10 A It doesn't suggest anything in
11 terms of what the affect of streaming is on CD
12 purchases.
13 Q Now, you made an assumption that
14 you testified about yesterday that subscribing
15 to the benchmark on-demand services could to
16 lead to two less CD purchases per year.
17 Correct?
18 A Yes.
19 Q And you adjusted for that in the
20 manner that you testified about?
21 A Right. And again, this is all
22 relationship, not that it will lead to two CDs

1 but that versus subscribing to a interactive
2 or non-interactive, would lead to two more CDs
3 being purchased.
4 Q And the number two, where did the
5 number two come from?
6 A Actually, I believe it was
7 suggested to me by counsel to see whether,
8 just to test it out in a simulation analysis.
9 Uhm --
10 Q Now -- sorry.
11 A I was just going to say, it seemed
12 like a reasonable assumption to me at the
13 time.
14 Q Now, from the label's perspective,
15 focusing on your benchmark market on-demand
16 services, they're collecting on average, or
17 the services are collecting, on average $8.29
18 per subscriber. Right? That was your
19 finding?
20 A That was my -- that was the
21 average price I used. Correct.
22 Q And based on the greater of

1 formulation and the 47.7 percent rev share, I
2 think it's fair to say, is it not, that
3 approximately $4 of that $8.29 would be
4 expected to flow through to the labels?
5 A I'll accept that.
6 Q At a minimum?
7 A Well, yes. It depends exactly how
8 the percentage of revenue applies, but
9 something like that.
10 Q Okay. Let's $4 because it's nice
11 and round.
12 A I'm fine with round numbers.
13 Q So that means that the labels are
14 getting $48 a year from those people that are
15 now subscribing to these on-demand streaming
16 conditional down-load services. Right?
17 A Right.
18 Q And if all they are losing from a
19 substitutional standpoint is two CDs a year,
20 if you calculate it, they'd be losing a little
21 bit over $10 and $11 in income by virtue of
22 that substitutional effect. Right?

1 A Yes, at $11.20, yes.
2 Q Now, that would put the labels way
3 ahead, wouldn't it? I mean, they're getting
4 $48 that they didn't have before by these on-
5 demand, streaming limited download services
6 and, with the two CD assumption, only losing
7 two CDs a year. So, they're coming away
8 pretty well off by this new form of
9 distribution. Right? It's $48 minus $10.50,
10 so they come away with $36 and change more
11 than they had before. Correct?
12 A I would expect that to be true and
13 I think that's entirely logical to suggest
14 that's what is going on. Otherwise, they
15 would not -- if they're not going to make much
16 on these services, they're not going to be
17 very intent to set the price where they do.
18 Q Well but isn't it true, sir, from
19 an economic perspective, they're ahead of the
20 game, even if those interactive services had
21 a substitutional impact of up to six or seven
22 CDs a year, or more than that?

1 A Well I think we -- let's get the
2 numbers right.
3 Q Well, if they're making $48 they
4 didn't have before, --
5 A Right.
6 Q -- and they're losing --
7 A A little over four CDs would be
8 where they'd -- four times, let's use $12,
9 round the $11.20 --
10 Q No, no, let's take on an income
11 perspective --
12 A $11.20.
13 Q -- you used $5 whatever it was, $5
14 --
15 A I used $11 -- I'm sorry. You're
16 right. $5, you're right, absolutely.
17 Q So it would be seven or eight CDs
18 --
19 A Yes.
20 Q -- that, even if those services
21 caused a substitutional impact of seven or
22 eight CDs, the labels are ahead of the game.

1 Right?

2 A Well, ahead of the game meaning

3 they make money on this service where above

4 and beyond what they were otherwise making,

5 yes. They're making money from their

6 different and new use of their copyrighted

7 material.

8 Q Well, my question is really, why

9 two? Why not consider a higher number

10 associated with the substitutional impact of

11 your benchmark market services, given the fact

12 that the labels are getting that $48 instead

13 of the substituted four CDs?

14 A Well, I think there are number of

15 reasons for this. First, if you start to make

16 this number much bigger, and we're doing some

17 rounding here, so I could quarrel with exactly

18 how much of the margin is accounted for by the

19 loss of CD sales, but if you make it too big,

20 you're positing that the record companies are

21 choosing to set a price for use of their music

22 and interactive webcasting which yields them

1 a very small margin. And it doesn't make
2 sense that they would be satisfied with a very
3 small margin, if that's what is happening at
4 that price. They'd try to raise the price and
5 as long as they don't cause a significant, an
6 overwhelming repression of demand, they're
7 going to make more money. The smaller your
8 margin, the more you're going to want to raise
9 your price because it doesn't cost you that
10 much when you lose customers. So, that's
11 number one.
12 Number two, two CD sales is a lot.
13 Even though the Arbitron data you showed me
14 and that I really initially reviewed showed
15 average CD sales of about ten per customer,
16 and higher numbers for certain classes of
17 customers, I think that's a vast overestimate
18 of the actual average annual CD purchases, if
19 you look at shipments of CDs in the United
20 States.
21 Q The bottom line is you chose two
22 because counsel recommended it --

1 A I --
2 Q -- and there's a big difference
3 between two and whatever number of CDs these
4 labels could afford to have substituted for
5 and still have a margin associated with your
6 benchmark market services. Correct?
7 A There is still, I agree there is
8 still a margin. I agree that there's a good
9 margin. And I agree that I chose two because
10 counsel suggested it. I also testify that
11 two, in my mind, is a very large number
12 relative to what we see of CD sales in the
13 country.
14 Q You are aware, are you not, that
15 record companies are making promotional
16 expenditures to promote air play of their
17 records by webcasters?
18 A Yes.
19 Q And that indicates to you, does it
20 not, that record company representatives
21 believe that those expenditures will result in
22 an increase in sales of recorded music.

1 Correct?
2 A Yes.
3 Q Now, in your adjustments that you
4 make in connection with your model, you don't
5 seek to capture or make any adjustment for
6 that promotional value of statutory licensed
7 webcasting, do you?
8 A I -- let's see for a second. The
9 promotional -- what I addressed in my
10 testimony is what I called net substitution or
11 promotion. So the two CD difference is an
12 attempt to show through simulation what would
13 be the effect on my recommendation if I had a
14 two CD positive difference which could either
15 be through increased substitution from the
16 benchmark, or could be from increased
17 promotion from the target. So, it considers
18 both ends of that. I just want to make sure
19 that's clear.
20 Q But you didn't consider
21 explicitly, on a standalone basis, what affect
22 that promotional value had on your model or on

1 the rate setting in this proceeding. Correct?
2 A I did not have, and similar to the
3 substitution numbers we were talking about, I
4 did not have any evidence of the extent to
5 which webcasting, in general, promotes the
6 sale of CD records. I'm not talking about
7 promotion of the particular hit albums, I'm
8 talking about the overall change in CD sales
9 that would be expected by the record company
10 as a result of having more customers
11 subscribing to statutory webcasting services.
12 Q You'd agree, through, as a matter
13 of just math, that if that relative two CD
14 assumption you made was larger, then that
15 would have an affect on what the rate is that
16 you would recommend to the panel. Correct?
17 A Yes.
18 Q And the larger that substitutional
19 differential, the lower the fee. Correct?
20 A Yes.
21 Q Turn, if you will, to page 18 of
22 your written testimony. This is where you

1 discussed the musical work, the benchmark.
2 A Yes.
3 Q First of all, the reference in the
4 first full paragraph on this page, where
5 you're talking about music services providing
6 interactive DATs, license fees for sound
7 recordings in the range that you put in your
8 testimony here, that's a direct reference to
9 your, what we talked about earlier, your
10 benchmark market interactive on-demand
11 streaming services. Right?
12 A Yes.
13 Q And the comparison that you make
14 and that you refer to in your footnote with
15 respect to musical works, that's the musical
16 work rate associated with those on-demand
17 streaming conditional download services and
18 the mechanical music licensing aspects
19 thereof. Correct?
20 A The performance and the
21 mechanical, yes.
22 Q You're familiar with the fact that

1 there's a difference between the mechanical
2 reproduction rights and the performance
3 rights?
4 A Yes, I am. And I think the
5 footnote discusses the dispute over whether a
6 mechanical fee applies or not.
7 Q Well, you know, don't you, that
8 there's no dispute over the application of the
9 mechanical royalty fee to conditional
10 downloads and permanent downloads?
11 A I wasn't sure about the
12 conditional downloads. I'll take your word
13 for it.
14 Q The dispute that you referred to
15 is whether or not there is a mechanical
16 reproduction in the delivery of an on-demand
17 stream. Right?
18 A Of an on-demand stream but then I
19 said here in the footnote, performance and
20 musical works by interactive services.
21 Q So this discussion here is in
22 relation to the musical work situation as it

1 pertains to on-demand streaming, conditional
2 download services, and actually permanent
3 download services, too. Right?
4 A Which part of the discussion? The
5 discussion in general is referring to the
6 amounts paid to the musical work copyright
7 holder for interactive services and it, as I
8 said in the footnote, it gives a range
9 depending on different interpretations of the
10 mechanical license fee of somewhere between
11 dispute ranging between 6.9 percent and 14
12 percent.
13 Q And that's what you read from this
14 article that you pulled up?
15 A Yes.
16 Q Now, so it's clear that the whole
17 discussion doesn't deal with the rates that
18 prevail for non-interactive statutory
19 webcasting services. Correct?
20 A I'm not exactly sure what your
21 question is.
22 Q The discussion doesn't relate to

1 musical work performance fees for non-
2 interactive statutory licensed webcasting.
3 Correct.
4 A This is pointing to markers
5 comparing where there are both of them
6 negotiated in the market. So, at this point
7 in the testimony, I only am referring to the
8 interactive. That's correct. Okay.
9 Q Now, You make a statement on this
10 page that differentiates between the factors
11 of production depending on their scarcity
12 value and then you say, to the extent that
13 popular recording artists are scarcer than
14 musical composers, the returns to the
15 recording artist will be higher. Do you see
16 that?
17 A I do.
18 Q You're familiar with the fact, I
19 think you actually may have testified to it a
20 little bit, that there are many songs that are
21 recorded by multiple people?
22 A Yes.

1 Q If I had a song that was recorded
2 by 20 different people and I wanted to have a
3 performance of that song, I could choose from
4 any one of 20 renditions of it. Correct?
5 A If I wanted to purchase it as a
6 consumer? I'm sorry, I know it's a little --
7 Q Whether you wanted to purchase it
8 as a consumer as a download or whether you
9 want to hear it as an interactive stream, if
10 there are 20 different versions of a song and
11 I'm neutral as to the performance, then which
12 is scarcer, the song or the performed version
13 thereof?
14 A If you're neutral then it's not
15 very scarce. If a customer is just as willing
16 to buy a song recorded by you versus Barry
17 Manilow, then, you know, Barry Manilow is not
18 going to get a lot of money for recording
19 music.
20 Q Well then, as a practical matter,
21 neither musical works nor sound recordings are
22 scarce. Correct?

1 A They are scarce from the
2 standpoint of how they're valued in the
3 market.
4 There is talent and what we're
5 talking about is scarce talent. It's the same
6 thing that operates in any market where there
7 are anyone can do it but not everyone can do
8 it well. So, I could play professional
9 basketball just as well as LeBron James but I
10 doubt I would get the same compensation he
11 gets. So, LeBron James is scarce.
12 Q You wouldn't get any compensation,
13 would you? You wouldn't be in that market
14 because you're not in that market.
15 A If the market is exclusively
16 professional basketball, that's correct, I
17 wouldn't be in it.
18 Q Now, you then make a reference to
19 screenwriters, actors and directors as a point
20 of your rationale here. Now, just to be
21 clear, screenwriters, actors and directors are
22 not licensed on a blanket license basis.

1 Correct?

2 A Correct.

3 Q So, individual negotiations occur

4 between whether it be motion picture or TV

5 companies and individual actors, directors and

6 scriptwriters over their primary compensation.

7 Correct?

8 A Yes. I mean, there's union

9 affects but, in general, I agree with you.

10 Q I want to ask you some questions

11 about your testimony about the mobile premium.

12 First of all, you'd agree that

13 CHIEF JUDGE SLEDGE: Mr.

14 Steinthal, before you go into that, you want

15 to take a recess for now?

16 MR. STEINTHAL: Sure.

17 CHIEF JUDGE SLEDGE: Recess for

18 ten minutes.

19 (Whereupon, the foregoing matter

20 went off the record at 11:02 a.m. and went

21 back on the record at 11:14 a.m.)

22 CHIEF JUDGE SLEDGE: We'll come to

1 order.

2 CROSS-EXAMINATION (CONT'D)

3 BY MR. STEINTHAL:

4 Q Dr. Pelcovits, questions about

5 mobile for a moment. Would you agree with the

6 proposition that the market for delivery

7 through mobile devices of webcast services is

8 a relatively new market?

9 A Yes.

10 Q Do you know exactly how new?

11 A Not specifically, no.

12 Q It's within the last several

13 months, isn't it?

14 A I believe that's correct. I was

15 going to say within the last year or so.

16 Q Now, is it correct that you have

17 to be, as an economist, cautionary about

18 making any broad economic assumptions based on

19 data from an immature market?

20 A I think there's limits, to some

21 extent, what you can say about it. I would

22 agree that you want more data and more

1 information, if possible, in making
2 conclusions, yes.
3 Q Isn't it true that pricing in new
4 markets can sometimes fluctuate wildly in the
5 first two or three years of a market?
6 A Yes, it can fluctuate, absolutely,
7 as products are being introduced and brought
8 to market, yes.
9 Q And is one of the things that can
10 lead to fluctuations in price as more and more
11 companies become engaged in the supply of
12 similar product?
13 A That's the competition in entry we
14 were talking about earlier. So, you've come
15 around to my side.
16 Q So, the answer is yes, is it not?
17 A Yes.
18 Q And are you familiar with the fact
19 that in the mobile business, in particular,
20 there has been a lot of different products
21 flowing into the market year by year?
22 A In the mobile market?

1 Q Yes.
2 A You're talking about mobile music
3 or just mobile in general?
4 Q Mobile telephony product-wise?
5 A Oh, sure.
6 Q And there are competing offerings
7 by mobile companies of different content that
8 people can subscribe to. Correct?
9 A Content, varieties of accessing
10 content. There's a lot of things going on in
11 the market, yes.
12 Q And a lot of that is emerging as
13 we speak. Correct?
14 A Yes.
15 Q Now, I believe on page 61 of your
16 testimony and then in your direct, you talked
17 about the inadequacy, maybe inadequacy is the
18 wrong word, the lack of a lot of observations
19 of data upon which you could rely. Correct?
20 A Yes.
21 Q In your written statement you say
22 the data is not rich enough, those are your

1 words, and then I think on your direct
2 testimony you said that you didn't have enough
3 observations upon which to make a conclusion
4 about mobile rates relative to other rates.
5 Correct?
6 A No. I said that I did not have
7 enough observations in order to extend the
8 hedonic regression. It didn't mean I couldn't
9 draw some conclusion that they are priced in
10 the market generally higher than the non-
11 mobile services.
12 Q Well, I think you said that six
13 observations were what you had for mobile and
14 they're the ones on page 60 of your testimony.
15 Is that right?
16 A That's correct.
17 Q If six observations are not enough
18 for you to do a regression analysis -- is that
19 what I understood you to say?
20 A It depends. I mean, you have to
21 try. We did try the regression analysis and
22 it didn't give anything meaningful. There was

1 not enough power in the regression to come up
2 with a significant coefficient estimate.
3 Q Well, if six observations aren't
4 enough, is there a rule of thumb to any degree
5 of how many observations you need to conduct
6 a regression that you can have any confidence
7 in?
8 A No.
9 Q Is it typically more than six?
10 A It depends on what you're trying
11 to regress. If you're trying to, you know,
12 look at a time trend for five years of, you
13 know, production of a particular product in a
14 new country, you might be able to do a
15 regression. You're essentially drawing a
16 straight line. People do it all the time and
17 they draw conclusions from it. So, six is not
18 necessarily insufficient. In this case it
19 was.
20 Q In this case it was insufficient?
21 A In order to extend the regrsssion
22 analysis, yes.

1 Q Now, the fact is that your
2 regression, as it relates to your benchmark
3 market, involved only seven interactive
4 services. Correct?
5 A I think, if you include the
6 portable and non-portable. I'd have to check
7 how many there were.
8 Q Well, if you include portable and
9 non-portable and don't double count, in other
10 words, if it's the same entity, it's Napster
11 and Napster to Go portable, and Rhapsody and
12 Rhapsody to Go portable, if you don't double
13 count those, isn't it true that the
14 observations that you used for your
15 regression, that you testified about earlier,
16 involved seven different services?
17 A I don't call it double counting if
18 they are two different prices available in the
19 market. There are some prices here that from,
20 for example, Rhapsody Radio and Rhapsody Radio
21 is provided by Rhapsody. So that is an
22 observation. As I said, --

1 Q So if we don't -- let's get over
2 the semantics about double counting or not.
3 You'd have ten observations if you included
4 portable and non-portable. Right?
5 A Sounds about right, yes, but I'd
6 have to double check.
7 Q So somewhere between six and ten
8 we have enough observations to go from
9 something that's not reliable to something
10 that is?
11 A It depends on the data and how the
12 data varies, how easy it is to explain it, how
13 consistent it is across the data. If you have
14 six observations that are very tightly grouped
15 and consistent across the board in their
16 characteristics, it might be sufficient to
17 draw a conclusion. You can look at the data
18 and, in fact, I would say that behind any
19 attempt to dig deeper into a regression, let's
20 look at an obvious, what the data says to you.
21 The regression is a technique to
22 work with the data. The regression is

1 consistent with what I showed here. It
2 doesn't take a lot of very fine tuned analysis
3 to see that overall there is a ratio between
4 interactive and non-interactive in the market
5 in this general range that I've talked about,
6 about 55 percent, give or take. That's not
7 true with respect to the mobile internet radio
8 services where the characteristics are
9 different from the non-mobile services with
10 respect to channels and other features so it's
11 very hard to sort out. And that's what a
12 regression would need to do and why it would
13 need more data. It needs to sort out the
14 specific effect of mobility on the price.
15 And that's the goal of the
16 regression and that's what I said by not
17 having enough data.
18 Q Let's talk about the data you did
19 have, okay?
20 A Yes.
21 Q The box on page 60.
22 A Yes.

1 Q Now, Mobzilla?
2 A Yes.
3 Q Do you know what Mobzilla is?
4 A I do. I tried it out. It's a --
5 I got it on my sign up and I think I did it as
6 a trial, I don't think I shelled out the
7 money. And you get to listen to whatever
8 channel, I think it was whatever channel you
9 preselected when you signed up and you listen
10 to it on your cell phone. I'm not sure how
11 you switch channels, but I'm aware, generally,
12 what it is.
13 Q Well, who does the consumer pay,
14 the phone company?
15 A They pay Mobzilla.
16 Q What is Mobzilla? Is it a
17 communications company or is it a webcaster?
18 A I don't know. It's available in
19 the market.
20 Q You don't know whether it's a
21 phone company or a webcaster?
22 A I don't know. I don't know who is

1 Mobzilla other than it is available in the
2 market, if you go to the market and try to buy
3 the service. And I did not buy this through
4 my phone company. So, whether they are owned
5 or partly owned by a phone company, it doesn't
6 matter to me. They are something that I, as
7 a subscriber to Verizon Wireless can get by
8 signing up online and paying my $4.
9 Q And you say the number of stations
10 is 30. Does that mean you can get 30 stations
11 delivered to your phone or do you choose -- or
12 --
13 A You can choose which of the 30 you
14 want to listen to. I don't recall how it sets
15 up, being able to switch channels, whether you
16 can do that. I think you can do that from
17 your phone. I don't recall exactly how its'
18 done.
19 Q Now, MusicChoice, --
20 A Uh-huh.
21 Q -- that's the same service that
22 delivers digital music to homes. Correct?

1 A I don't recall.
2 Q Do you know how the price point
3 here of $5.95 relates to what consumers pay if
4 they pay on an a la carte basis for the
5 MusicChoice service delivered to the home?
6 A No, I don't.
7 Q Skip down to Sirius Sprint.
8 That's the satellite service, is it not, that
9 operates under the SDARS statutory license?
10 A That is, it's the Sirius part of
11 it, but it's marketed through Sprint, I
12 believe. Q Well it's true, is it
13 not, that the channels being delivered there
14 are the same channels available on satellite
15 radio through Sprint, but available here on
16 the webcast market. Right?
17 A It's the same programming for 20
18 channels. You get 20 of the channels.
19 Obviously, not all of them.
20 Q Now, The satellite services are
21 delivered to a stationery, -- they're
22 delivered to a device that you can only listen

1 to in your car. Correct? Under the statutory
2 license?
3 A I know that Sirius and XM, the two
4 satellite providers, are now selling or
5 providing service through other radios. They
6 don't have to be in your car.
7 Q Well, you've read about the
8 challenge by the recording industry to those
9 devices, have you not?
10 A I have not.
11 Q You're aware that the recording
12 industry is seeking to have legislation passed
13 that makes sure that the Satellite companies
14 can't take the or sell devices that would
15 enable consumers to capture the streams and
16 then play them back?
17 A First of all, that isn't what I
18 was talking about. You said, do you have to
19 listen to it in your car? You can get a
20 Sirius radio and carry it around with you or
21 put it by your beside. I was just commenting
22 on what's available in the market. I'm not

1 basing or saying anything about what anyone is
2 claiming before Congress or anyplace else.
3 Q Now, you would agree, however,
4 with the proposition that satellite radio, as
5 delivered through XM and Sirius, is not as
6 portable as delivering music by cell phones.
7 Right?
8 A I would say, presently, that's
9 probably the case, given the devices we have
10 now and given not just portability, but just
11 the ubiquity of, at present, of cell phones,
12 rather than satellite receivers.
13 Q And certainly prior to today, and
14 in the years 2003, 4 and 5, the XM and Sirius
15 services have not been available on as
16 portable a basis as cell phones provide.
17 Correct?
18 A Well, portable meaning are they
19 small, can you carry them everywhere, correct.
20 In terms of being available in your car, they
21 are, I would say, easier to use, in some
22 sense, in that sense, more portable than

1 trying to hook up a cell phone to your car's
2 audio system.
3 Q Well --
4 A I mean, I've tried to listen --
5 I've listened to XM in my car and I've tried
6 to listen to things from my cell phone in my
7 car, and it's a lot easier to listen to XM.
8 Q In your car?
9 A In my car.
10 Q But when you're not in your car,
11 it's a lot easier to listen, that's the whole
12 point of your discussion about mobile service
13 premiums is that you can listen to music
14 anywhere. Right?
15 A Anywhere -- yes, virtually
16 anywhere. It depends on how good your cell
17 phone reception is.
18 Q Certainly not in my hotel.
19 Now, what I'm trying to understand
20 here is, you say that the data reflects that,
21 and this is on page 60, the new mobile
22 services appear to command a premium in the

1 marketplace. Right?
2 A Yes.
3 Q Now, the Sirius service, when it's
4 purchased for the car, costs twice that
5 amount, doesn't it?
6 A That's about right, yes.
7 Q So, where we have a situation
8 where when I'm purchasing my subscription to
9 Sirius which, up until now has been limited
10 utility in the car, subject to your testimony,
11 I pay $12 a month, but now, now that I can
12 have it on my mobile phone, I'm going to pay
13 half as much. Not twice as much, half as
14 much. Right?
15 A If you want to just look at price
16 without looking at that other column there,
17 number of channels, 20. So, you can do any
18 calculation you want.
19 You can say on a per channel
20 basis, you're paying a lot more for Sirius on
21 a Sprint phone than you are for Sirius in your
22 car.

1 Q And have you done any study of how
2 many different channels people tend to listen
3 to when they subscribe to Sirius?
4 A How many they listen to and not
5 how many are available? No.
6 Q Okay. And did you consider, in
7 your testimony that talked about how mobile
8 services typically command a premium, that
9 with respect to one of the services on your
10 chart, in fact the price for the mobile
11 service is half as much of the price of the
12 offline service, if you will, off-mobile
13 service?
14 A You're just asking with respect to
15 Sirius, to be specific?
16 Q That's one of the six observations
17 you have here, yes.
18 A And I would repeat my answer,
19 which is, it's not the same service if you're
20 getting 20 channels rather than over 100
21 channels.
22 Q Now, with respect to MSpot Radio

1 and MSpot Music Radio, what are those
2 services? What is the difference between the
3 two?
4 A At this point, I don't recall.
5 Q Are they owned by different
6 companies?
7 A As I said, I don't recall.
8 Q Do you they operate statutory
9 license webcasting services or different kinds
10 of webcasting services?
11 A I don't recall.
12 Q What about Mobzilla? Do you know
13 whether they are operating services under the
14 statutory license or not?
15 A I don't know but the nature of the
16 service, as I have used it, is similar to a
17 statutory land line service in the sense of
18 being a stream of preprogrammed music.
19 Q You haven't analyzed whether it's
20 within or not the sound recording performance
21 compliment?
22 A No. I've looked at this from the

1 consumer standpoint.
2 Q Is MSpot Radio sold by a company
3 that is a programmer of webcasting under the
4 statutory license or a telephone company, a
5 mobile company?
6 A I don't recall.
7 Q Do you know whether any of the
8 prices include the price of delivery?
9 A What do you mean by that?
10 Q It wasn't a very good question.
11 I'll rephrase it.
12 Are you familiar with the fact
13 that mobile phone providers sell access to a
14 number of things, right? At this point?
15 A Yes.
16 Q They sell access to telephone
17 service. Correct?
18 A They provide telephone service.
19 Q Right. And they provide a series
20 of programming options that consumers can
21 choose to buy or not from the cell phone
22 company?

1 A I mean, I wouldn't put it that
2 way. They provide, you know, options of
3 different packages that the customer can get
4 which have a whole set of attributes.
5 Q Well, I'm trying to figure out
6 whether you know whether, in connection with
7 these services, what the relationship is
8 between the mobile company and the actual
9 provider of the content. In other words, does
10 to the consumer contract with the phone
11 company to obtain the delivery of the service
12 and then the phone company have a relationship
13 with the service itself?
14 A In some cases the customer does
15 business with the cell phone company and, in
16 other cases, this is provided independently.
17 Q Well, in which cases is it that
18 the consumer has the relationship with the
19 cell phone company?
20 A Sirius Sprint. I don't know about
21 the others. I do know that there has been,
22 you know, various, very changing deals offered

1 by Sprint. So, I don't know if any of the
2 other cell phone companies have been very
3 active at marketing music services.
4 Q Do you know whether any of the
5 companies operating under the statutory
6 license are making their webcasts available
7 through cell phone companies today?
8 A Well, the Rhapsody services, it's
9 the same company that's offering the customer
10 among its various services, the mobile
11 service.
12 Q Well, do you know whether the
13 Rhapsody service that's available on mobile
14 requires you to contract with the mobile
15 company from whom you get your cell phone
16 reception?
17 A I don't believe it does.
18 Q Do you know that one way or the
19 other?
20 A I'm not certain but I would, quite
21 frankly, I'd expect it's similar to Mobzilla,
22 that they could -- certainly, Rhapsody can set

1 up a system that customers can connect to
2 without having to purchase or designate that
3 with their cell phone company. It's certainly
4 technology that's there. I've used it. It
5 works.
6 Q Do you know whether any of that
7 $6.95 that you put down for Rhapsody goes to
8 the cell phone company that enables the
9 delivery to the consumer?
10 A Not that I know of.
11 Q You don't know one way or the
12 other?
13 A I'm not certain but if the service
14 can get that to the customer without the cell
15 phone companies active participation, they
16 don't have to give any to the cell phone
17 company.
18 Q And do you know whether it's
19 possible to get it to the cell phone user
20 without the active participation of the cell
21 phone company?
22 A They don't have to agree to it, as

1 long as they don't block it. It's a
2 broadband, it's a stream of bits and, if the
3 customer has the right equipment, it can be
4 put over the air and, as any sort of bits are
5 put over the air, and the customer can listen
6 to it. I mean, I've done it. I know it
7 works.
8 Q Now, let me ask you this question.
9 When a consumer buys a CD at a store, let's
10 call it $16.95 for the sake of argument, you
11 pay just $16.95 for the CD, if that's all
12 you're going to buy, and you walk out. Are
13 you with me so far, just in terms of --
14 A Yes. We've lost our round
15 numbers.
16 Q Okay. Yes, well, we're not going
17 to do much math with his.
18 A Okay.
19 Q If you're home and you call the
20 store and you say, look, I really want the new
21 CD that came out, will you FedEx it to me and
22 the store says yes, then you would expect,

1 would you not, that the consumer would pay the
2 $16.95 plus the cost of delivery. Right?
3 A If you want it overnight, yes.
4 Q Now, are you familiar with the
5 fact that there are a number of products being
6 sold by mobile companies where the consumer
7 pays an aggregated fee for the product plus
8 the cost of delivering right there on your
9 mobile phone?
10 A Yes, ringtones, V CAST type of
11 things, other types of content, yes.
12 Q If, in the situation where you
13 were buying something that has a market value
14 of X and then you're asking that it be
15 delivered in a particular way, have you heard,
16 in the economic literature, the reference to
17 that situation as being an aggregated price,
18 with some portion of it being for delivery?
19 A Not in that terminology but there
20 is certainly -- if you're trying to say that
21 something has a cost to be able to listen to
22 it in addition to what you have to pay from

1 the, let's say the store, or whoever is
2 providing it to you, that is the cost to the
3 customer and the customer is incurring a cost.
4 So, if a customer has to subscribe and pay
5 more to his cell phone company and pay an
6 extra $4 to be able to have the right to get
7 Mobzilla, then the customer is still paying $4
8 to Mobzilla. And that's -- those are the
9 prices I'm showing you. I'm not showing the
10 final cost to the customer. I'm not including
11 the cost here, I'm not including that in the
12 cost of the equipment needed to play CDs or
13 the computers needed to play webcasts.
14 Q And you don't know how much of
15 this monthly price listed for the six
16 observations that you've made, consists, if at
17 all, of delivery charges. Right?
18 A In some cases, clearly none. In
19 other cases some. But in all cases, it's what
20 the customer pays and it's an indication that
21 customers will pay a premium to have music
22 streamed to their cell phones, compared to

1 just being able to get it on their computers.
2 Q And is it your testimony that even
3 though the product may be identical and the
4 difference in cost to the consumer may be the
5 cost payable to the phone company for
6 delivering it in the fashion of a mobile
7 device, that the sound recording companies
8 should get an increased royalty merely because
9 there's a delivery component in the cost to
10 the consumer?
11 A That's too long a question for me
12 to answer. I'm serious. I didn't comprehend
13 it.
14 Q Well, in the hypothetical of a
15 situation where it's the identical music being
16 delivered over the computer and over the cell
17 phone and to the customer, they pay a greater
18 fee of $2 than they would otherwise pay for
19 example, --
20 A Pays $2 more?
21 Q Right.
22 A Okay.

1 Q If it subscribes to the service
2 through the mobile company rather than just
3 the internet service, would you attribute the
4 entirety of that $2, which enables you to get
5 the service by mobile as well as by computer,
6 to the revenue base against which a sound
7 recording royalty would apply?
8 A Not necessarily and I don't think
9 it would matter whether there is a cost, a
10 share of this paid to the cell phone company
11 or there is a cost the customer incurs to get
12 the service. I'm -- the share of revenue that
13 I think the copyright holders should get
14 should reflect the value to the consumer and
15 a higher price is indicative of a higher value
16 to the consumer. Part of that might be
17 because it's more expensive to get it to him.
18 Part of it might be, you know, various other
19 reasons. But I hope that answers it. I was
20 struggling.
21 Q Let me ask you to move to page 57
22 of your report. Am I correct that in pages 57

1 up to the top of 58 what you've done is
2 compare the ratio of prices charged by sound
3 recording companies for preprogrammed or non-
4 interactive music as compared to interactive
5 music?
6 A No. I both do that comparison and
7 I also present the share of revenue that is
8 received for both types of video, music
9 videos.
10 Q Well, let's focus on the ratio.
11 First of all, you've, in your testimony,
12 recommended that when we look at the relative
13 value of a benchmark market on-demand service
14 compared to a target market non-interactive
15 service, we should look at the difference
16 between what the consumer pays for the
17 benchmark market service as compared to what
18 the consumer pays for the non-interactive
19 service. Right?
20 A Right.
21 Q Now, you could look at it the
22 other way. Right? You could, if you wanted

1 to look at ratios of value, look at the
2 difference between what the seller charges for
3 interactive product compared to what the
4 seller charges for non-interactive product.
5 Right?
6 A I assume the consumer buys what
7 the seller sells. So, that's the market
8 price. I don't know -- I don't understand the
9 distinction that you're trying to draw.
10 Q Well you have focused, for the
11 model you want to put forward here, on what
12 consumers pay for two different kinds of
13 services, your benchmark market service, which
14 is interactive on-demand streaming, and your
15 non-interactive target market services.
16 Right?
17 A Yes.
18 Q Now, that doesn't tell us what the
19 sound recording companies value their
20 copyrights for in terms of the relative value
21 from their perspective, as they sell their
22 product. Does it?

1 A It doesn't. And primarily, the
2 statutory rate is set in one case and the
3 other is based on a willing buyer and a
4 willing seller.
5 Q Well, let's focus on the willing
6 sellers because the consumer is not either the
7 willing buyer or the willing seller in the
8 willing buyer/willing seller analysis that the
9 panel has to set. Right?
10 A That's correct.
11 Q So, let's focus on the seller.
12 You would agree, would you not, that as you
13 discuss here on page 57, when the sound
14 recording sellers sell licenses to music
15 videos for streaming on the internet, they set
16 rates that are differential, typically, from
17 what they charge for on-demand interactive
18 streaming as distinguished from preprogrammed
19 non-interactive streaming. Right?
20 A On a per stream basis or a per
21 play basis, yes. Not on the revenue
22 percentage.

1 Q But on a per stream basis, the
2 ratio, I think, you point out, on page 57
3 carrying over to 58, is roughly five to one?
4 A Right.
5 Q So that the non-interactive stream
6 is something they charge on a per play basis,
7 one-fifth of the on-demand stream. Right?
8 A When that's what's actually paid
9 on the greater of contract, yes. That
10 characterizes that part of the rate structure.
11 Q And are you familiar with the fact
12 that,--
13 MR. STEINTHAL: And I'm going to
14 ask this question and ask that the question
15 and answer be restricted, Your Honor, because
16 it reveals information provided by one of the
17 labels on a restricted basis. So, I'm just
18 assuming that if I were to ask the witness
19 whether he's aware of the particular price
20 point of a particular label, the gentlemen on
21 the other side would request that we have that
22 restricted. It's just one question and

1 answer.

2 CHIEF JUDGE SLEDGE: Your motion

3 is not sufficiently specific to generate a

4 response.

5 (Whereupon, the foregoing matter

6 went off the record at 11:47 a.m. for a closed

7 session.)

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1 BY MR. STEINTHAL:
2 Q In doing your comparability
3 analysis, sir, as between the target market
4 and the benchmark market services, you didn't
5 consider the fact that one is subject to
6 statutory licensing and one is not. Correct?
7 A In the sense of -- yes, that's
8 underlying my analysis is the facts are what
9 they are in the market. I did consider it
10 because if it wasn't a statutory rate in one
11 market and it was -- they were both willing
12 buyer and willing seller, we wouldn't have to
13 be here.
14 Q Okay. That's a fair answer.
15 Putting that aside, that we wouldn't have to
16 otherwise be here, did you take into
17 consideration any Congressional intent
18 associated with services operating under the
19 statutory license?
20 A If you mean legislative history,
21 no.
22 Q So you didn't consider any factors

1 that may underlie why the statutory license
2 exists in the first place? Any legislative
3 history factors, to be clear?
4 A I did not.
5 Q Would it affect your analysis at
6 all if you were aware that labels in
7 establishing the prices in your benchmark
8 market in part did so with an intent to
9 establish good precedent for statutory rate
10 setting?
11 MR. HANDZO: Objection. I think
12 this was asked and answered yesterday.
13 CHIEF JUDGE SLEDGE: Mr.
14 Steinthal?
15 MR. STEINTHAL: I'm pretty
16 confident I didn't ask that question.
17 CHIEF JUDGE SLEDGE: You're asking
18 him to conjecture on the opinion of someone
19 that entered into a contract?
20 MR. STEINTHAL: I'm asking him
21 whether it would affect his analysis if he had
22 evidence that labels, in establishing prices

1 in the benchmark market, did so in part to
2 establish precedent for statutory rate
3 setting?
4 MR. HANDZO: In addition to the
5 Court's concerns, I'm fairly confident that he
6 did ask that question because I can tell you
7 what the answer is. He can get it again from
8 the witness, but he's already answered it.
9 CHIEF JUDGE SLEDGE: Objection
10 overruled.
11 THE WITNESS: I frankly don't
12 remember what I said before. So, I would have
13 to say, would it affect my analysis? I
14 basically say I can't answer that in the
15 abstract. I think there's far too much market
16 evidence for me to think that this is being
17 driven by intent to affect the statutory rate.
18 BY MR. STEINTHAL:
19 Q Now you're aware, are you not,
20 that in 2003, two years before you undertook
21 to conduct the analysis underlying your model,
22 that SoundExchange and its label members

1 voluntarily agreed to rates for statutory
2 license webcasts under a different framework,
3 correct, a licensee option?
4 A Right. There wasn't added option
5 to the 0.007 cent per play.
6 Q But you're aware that two years
7 before you did your model, there was a
8 voluntary agreement between SoundExchange and
9 the webcasters that established rates, at the
10 licensee's option for subscription services of
11 10.9 cents -- sorry, 10.9 percent with a 27
12 cent per sub minimum or a per usage rate
13 either based on a 0.0007 cents per play or
14 1.17 cents per hour?
15 A I am aware of that.
16 Q Now, as of 2003 when that
17 agreement was entered into, the interactive
18 services in your benchmark market already had
19 an established rate structure of the greater
20 of, essentially, 50 percent of revenue, a
21 penny a play, or somewhere between $2.50 and
22 $3 per sub, isn't that right?

1 A Yes.
2 Q If you recall in reference to your
3 testimony about table 6.2, you said that you
4 wanted to have a sanity check on your
5 regression, right? And that's partially what
6 6.2 was?
7 A Yes.
8 Q Did you do any sanity check of
9 your model's results against what the
10 recording industry voluntarily agreed two
11 years beforehand?
12 A That would be an insanity check.
13 I mean, to apply a carry forward of a rate
14 from a previous CARP decision rather than
15 reenter into another litigated situation is
16 not a market. So, that would not be sane.
17 Q As an economist you don't presume
18 that actors enter into deals that they don't
19 believe are acceptable for them under the
20 circumstances in the market at the time
21 they're negotiating. Correct?
22 A Under the circumstances, the

1 market including all of the institutional,
2 legal and other factors that are present
3 affecting what they believed they would get if
4 they didn't complete the negotiation.
5 Q And that's true as to both sides
6 to a negotiation, in your view. Right?
7 A Yes.
8 Q And I gather then that because you
9 felt that it was an insanity check, you didn't
10 seek to conduct any analysis of why it was
11 that your model came out to the results that
12 it came out to so disproportionately to the
13 voluntary agreement that was entered into by
14 SoundExchange in 2003?
15 A I've already said, I think, that
16 whether it's the original CARP rate or the
17 carry forward that was agreed to, that that
18 was not a market determined rate because it
19 was either set by the CARP or carried forward
20 to avoid another hearing right away.
21 Q Now, on page 29 to 30 of your
22 written statement and also on your direct

1 testimony, you pointed out that if you take in
2 isolation just one of the three elements of a
3 greater of formula, either the per sub, the
4 per play, or the percentage, you, in essence,
5 undervalue that element. Correct?
6 A I don't know if I used the
7 undervalued but I said it would not take
8 account of the tradeoffs that went into the
9 greater of formulation and would lead to a
10 lower rate than would otherwise be
11 appropriate.
12 Q If you turned it around, flipped
13 it over, and you were looking at a lesser of
14 or licensee option framework, the same would
15 be true, would it not, in the sense that if
16 you were looking at a lesser of formula and
17 you had a choice of choosing to play on a per
18 play, per hour, or percentage of revenue rate,
19 then looking at any one of those elements on
20 their own, would effectively overestimate the
21 actual amount agreed to. Correct?
22 A If you were to adopt that.

1 Looking at it and adopting it are two
2 different things. But if you were to take a
3 three part lesser of structure and just get
4 rid of two of the three options, it would do
5 that.
6 MR. STEINTHAL: I have no further
7 questions, Your Honor.
8 Oh, one minor thing, Your Honor.
9 I wanted to move into evidence one of the
10 schedules from the witness, which I think
11 would be helpful to the panel as well. I'm
12 going to mark as Services Exhibit 63,
13 Attachment A to the witnesses report.
14 (Whereupon, the above-
15 referred to document
16 referred to as Services
17 Exhibit No. 63 was
18 marked for
19 identification.)
20 CHIEF JUDGE SLEDGE: Is this
21 identification for something in the direct
22 statement?

1 MR. STEINTHAL: It's not in the
2 actual, the direct statement, but it's
3 referred to. If it was in, we wouldn't be
4 doing this. It was produced in discovery.
5 Let me just ask the witness.
6 BY MR. STEINTHAL:
7 Q Is this schedule a schedule of 17
8 agreements and the details about the 17
9 agreements which you testified about
10 underlying the benchmark market?
11 A Let me check. Yes.
12 MR. STEINTHAL: I'd offer Exhibit
13 63 into evidence.
14 CHIEF JUDGE SLEDGE: Any objection
15 to Exhibit 63?
16 MR. HANDZO: No, Your Honor. I
17 would note, however, that it was produced
18 subject to the protective order and,
19 therefore, ask that it be designated as
20 restricted in this record.
21 CHIEF JUDGE SLEDGE: There being
22 no objection, the exhibit is admitted.

1 (Whereupon, the document
2 marked as Services
3 Exhibit No. 63 for
4 identification was
5 received into evidence.)
6 CHIEF JUDGE SLEDGE: Any objection
7 to submitting the exhibit to the provisions of
8 the protective order?
9 (No response.)
10 CHIEF JUDGE SLEDGE: With no
11 objection, the motion to submit to the
12 provisions of the protective order is granted.
13 Mr. Steinthal, you are now
14 concluded?
15 MR. STEINTHAL: Yes. Thank you,
16 Your Honor.
17 CHIEF JUDGE SLEDGE: Mr. Joseph,
18 do you wish to begin your cross-examination
19 for a half an hour?
20 MR. JOSEPH: I do, Your Honor.
21 CHIEF JUDGE SLEDGE: All right.
22 MR. JOSEPH: Although I would

1 appreciate about three minutes to do the
2 transfer of places.
3 CHIEF JUDGE SLEDGE: Go right
4 ahead.
5 MR. JOSEPH: Thank you.
6 THE WITNESS: Could I use that
7 three minutes to run to the mens' room, Your
8 Honor?
9 CHIEF JUDGE SLEDGE: Certainly.
10 THE WITNESS: Thank you.
11 CHIEF JUDGE SLEDGE: We'll recess
12 for five minutes.
13 THE WITNESS: Okay. Wonderful. I
14 appreciate it.
15 (Whereupon, the foregoing matter
16 went off the record at 12:02 p.m. and went
17 back on the record at 12:06 p.m.)
18 CHIEF JUDGE SLEDGE: We will come
19 to order. Mr. Joseph?
20 MR. JOSEPH: Thank you, Your
21 Honor.
22 BY MR. JOSEPH

1 Q Good afternoon, Mr. Pelcovits. We
2 met, of course, at your deposition. Right?
3 A Good afternoon -- or -- yes, it
4 is. Good afternoon, Mr. Joseph.
5 Q I was waiting to see whether I was
6 going to get to say good afternoon or good
7 morning. But we crossed that.
8 Just to start, to make sure that
9 we're speaking the same language, Dr.
10 Pelcovits, your written testimony uses a
11 couple of terms that we didn't hear yesterday
12 and today. And I just want to make sure we
13 understand them.
14 I believe one of the terms is
15 interactive DAT and NI-DAT. Correct?
16 A Yes.
17 Q Okay. And by interactive DAT, in
18 your written testimony, and I think at times
19 in your deposition when we were talking back
20 in early March, you mean interactive digital
21 audio transmission services. Correct?
22 A Correct.

1 Q And yesterday in your oral
2 testimony and, I think, at times today, you
3 referred to the market for these sound
4 recording performance license for those
5 services as your benchmark market. Correct?
6 A Yes.
7 Q And by NI-DAT, you meant the non-
8 interactive webcasters covered by the
9 statutory license. Correct?
10 A Correct.
11 Q And you referred to the market for
12 sound recording performance licenses for NI-
13 DAT services as your target market. Correct?
14 A Correct.
15 Q Okay. Now, with respect to each
16 type of service, would it be accurate to say
17 that there are at least two markets? On the
18 one hand, the market for the sound recording
19 performance license, which is a market where
20 the seller is the licensor or the record
21 companies and the buyers are the services and
22 a market for the services to consumers where

1 the sellers are the services and the buyers
2 are consumers?
3 A Yes.
4 Q Now, a little earlier today when
5 you were talking to Mr. Steinthal and said
6 that you used a competitive market model for
7 the purpose of estimating the rate, you were
8 referring there, I believe, you also testified
9 to your model, assuming that the consumer
10 market for the webcasting services was
11 competitive, not necessarily that the
12 benchmark market for the sound recording
13 licenses was competitive. Correct?
14 A That's what I was referring to,
15 yes.
16 Q Now, in fact in your analysis you
17 didn't make any assumptions about the
18 competitive status of your benchmark market.
19 You just took that market as it is. Correct?
20 A It's fair to say I took the market
21 as it is and I think I said in my testimony,
22 I believe, that there's no monopoly power in

1 that market, in the market, in the record
2 industry as a whole. That it's a workably
3 competitive market.
4 Q And you base that, if I understood
5 your testimony, on the prior CARP decision and
6 then on a review of changes in that market as
7 a result of the Sony-BMG merger and the review
8 of that merger by the Federal Trade Commission
9 and the European Commission. Correct?
10 A I based the adoption of using the
11 sellers as they are now based on the previous
12 CARP decision. It's straight forward
13 application except with respect to the change
14 in the industry from B5 to B4.
15 I based my statement on the market
16 being generally workably competitive, is the
17 term I think I used in my deposition to refer
18 to the record industry as a whole on the
19 findings of the Federal Trade Commission that
20 approved the BMG-Sony joint venture, subject
21 to the anti-trust laws.
22 Q Now, if you please turn to page 10

1 of your written statement where there's a
2 paragraph that I believe was referred to
3 yesterday, or a sentence at the end of the
4 first paragraph, where you say the willingness
5 of a seller to offer a service at a particular
6 price is, in large measure, a function of its
7 cost, the effect of sales of one service on
8 sales of other services sold by the same
9 company, and the intensity of competition in
10 the marketplace, both in the large and the
11 short run.
12 It's true, is it not, that you
13 didn't analyze your benchmark market to
14 determine the intensity of competition in that
15 market. Correct?
16 A Other than to refer to the federal
17 government's review of the market as a whole,
18 I did not.
19 Q Now, just to be clear with respect
20 to your reliance on the prior CARP decision,
21 do you understand the CARP in 2001 to have
22 analyzed the licensed, the market for sound

1 recording licenses for interactive digital
2 audio transmission services to determine
3 whether it was competitive?
4 A I believe they adopted it and
5 accepted the competition in the market, as it
6 stood at that point. Exactly how they
7 referred to it, the term competitive, or
8 whatever, I don't recall.
9 Q Now, when you say they adopted it
10 and referred to the market, I'm referring here
11 specifically to the market for sound recording
12 licenses for interactive digital audio
13 transmission services. Did you understand the
14 CARP to have analyzed whether or not that
15 market was competitive?
16 A I don't recall that I made a
17 specific analysis of the term, whether it's
18 competitive or not. I'd have to go back and
19 look.
20 Q Do you recall whether they
21 analyzed that particular market at all?
22 A Well, they used that market for

1 the basis of determine what a willing seller
2 was. And they said that the willing sellers
3 were the record companies.
4 Q So it's your understanding that
5 the CARP used the market for the sale of sound
6 recording licenses to interactive digital
7 audio transmissions services as the basis for
8 its decision?
9 A I don't know if you can say they
10 used the market. They used the sellers in the
11 market and they treated those as the willing
12 sellers.
13 Q But did they analyze that market
14 specifically?
15 A I don't recall.
16 Q Well, do you recall your
17 discussion with Mr. Steinthal earlier this
18 morning where it was represented that that
19 market barely had started by 2002?
20 A Yes.
21 Q So, at the time that the CARP was
22 deciding, there wouldn't have been very much

1 to analyze with respect to that particular
2 market, would there have been?
3 A Well, you're looking at a market.
4 It's one of the many markets in which sound
5 recordings are provided. And I would say you
6 can't, in terms of any market competition
7 analysis, just say let's look at one piece of
8 the market without looking at the entire
9 behavior and actions of the record companies
10 as an industry in and of itself. It's an
11 industry that sells in multiple channels. I
12 would not look at the sale in a particular
13 channel as an analysis of workable
14 competition.
15 Q So, it's your testimony that when
16 anti-trust authorities review mergers, they
17 don't look at each of the markets in which the
18 sellers participate?
19 A They might. They might not. It
20 depends on the nature of those markets, the
21 firms in the market, and how they go about
22 analyzing it.

1 Q Well, do you understand the prior
2 CARP to have actually analyzed whether any
3 market for the licensing of sound recording
4 performance rights was competitive?
5 A I know they used the working --
6 I'm sorry. They used existing record
7 companies as the willing sellers. Exactly how
8 thy referred to competition and what
9 specifically they said about the nature of the
10 competition in the market, I don't recall. I
11 do recall they looked at the issue of how does
12 a market function and they adopted, as I said,
13 willing sellers as the record companies. They
14 chose that as the market to look at.
15 Q But I'm not sure -- I don't
16 believe that answered my question. My
17 question was, do you know whether the prior
18 CARP actually analyzed whether any market for
19 the licensing of sound recording performance
20 rights was competitive?
21 A I don't know what they analyzed.
22 I know there's some statements about

1 competition in the market. I don't recall the
2 specific wording or contents.
3 Q And do you have any understanding
4 of what evidence, if any, was presented to the
5 CARP on the question of whether and to what
6 extent the record companies competed with each
7 other for the licensing of sound recording
8 performance rights?
9 A I don't believe it. I believe
10 they looked and compared the option of -- they
11 compared the option of either looking at the
12 copyright holder having the copyright or
13 multiple parties having the same copyright
14 right. And they said the purpose of using
15 this standard was to look at the actual
16 copyright holder having that right.
17 Q Sir, once again, I don't -- maybe
18 my question wasn't clear. Let me try it
19 again. But I don't think you answered it.
20 I asked whether you had any
21 understanding of what evidence, if any, was
22 presented to the CARP on the question of

1 whether and to what extent the record
2 companies competed with each other for the
3 licensing of sound recording performance
4 rights? And do you have any understanding of
5 what evidence, if any, was presented to the
6 CARP on the question of whether and to what
7 extent the record companies compete with each
8 other as sellers in any market? What
9 evidence?
10 A Right. I do not know what
11 evidence was presented to them.
12 Q And I take it you would agree that
13 the CARP did not evaluate whether any
14 particular agreements negotiated by the
15 existing record companies were negotiated in
16 a competitive market, but instead relied on an
17 agreement between the RIAA collective and
18 Yahoo as its primary benchmark. Correct?
19 A That was the benchmark they relied
20 on. I'll agree with that.
21 Q Would you -- do you know whether
22 they evaluated whether any particular markets

1 negotiated by the record companies were
2 negotiated in a competitive market?
3 A I do not recall.
4 Q Wold you agree that the market for
5 the sale of physical CDs is a different market
6 than your benchmark market, the market for the
7 sound recording performance right for
8 interactive digital services?
9 A Can we be precise on terminology?
10 Do you mean the sale of CDs by the record
11 companies to the retail outlets or the
12 retailing of CDs overall?
13 Q Sale of CDs to the retail outlets
14 to the record companies.
15 A And the question is, do I regard -
16 - is that a different market from the market
17 for the sale of or the provision of
18 performance rights to the webcasting services?
19 Q Well, to the interactive digital
20 services, your benchmark market.
21 A Right. Do I think it's a
22 different market? It is a different market

1 with very similar characteristics. With very
2 similar characteristics.
3 Q Now, I believe yesterday, at one
4 point in your testimony, I think it was on
5 direct, you said that the "market has been
6 found to be competitive." Can you tell me,
7 first of all, what market you were referring
8 to when you said that?
9 A I was referring to the record
10 industry as a whole and looking at whether the
11 industry is workably competitive, I think, is
12 generally the term I prefer to use because we
13 don't almost ever see a perfect textbook
14 competition. But, that's what I was referring
15 to.
16 Q And again, by found to be
17 competitive, you were referring to the fact
18 that the FTC decided not to challenge the
19 Sony-BMG merger?
20 A That's what I'm referring to, yes.
21 Q By the way, in considering that
22 issue, did you also take into account and

1 review the European Commission decision with
2 respect to the Sony-BMG merger?
3 A I did.
4 Q And are you relying on that for
5 your conclusion about the finding to be
6 competitive as well?
7 A I'm relying on both of those
8 decisions to support a general statement that
9 the record industry is workably competitive,
10 not to try to analyze any specific market in
11 which they participate.
12 Q Now, considering the Sony-BMG
13 merger to which you have referred, is it your
14 understanding that the Federal Trade
15 Commission would have applied the FTC and
16 Department of Justice merger guidelines in its
17 analysis?
18 A Yes.
19 Q Did you review the merger
20 guidelines?
21 A I have many times, yes.
22 Q And one of the things that the FTC

1 would have looked at when it was evaluating
2 the merger was the concentration of the sound
3 recording industry. Correct?
4 A Yes.
5 Q And, if anything, the Sony-BMG
6 merger made the sound recording industry more
7 concentrated than it previously was. Correct?
8 A Yes.
9 Q Now, it's true, is it not, that
10 the primary measure of concentration used by
11 the Justice Department and by the Federal
12 Trade Commission when it evaluates mergers is
13 something called the Herfindahl-Hirschman
14 index. Correct?
15 A Yes.
16 Q And can you explain how the
17 Herfindahl-Hirschman index for an industry is
18 calculated?
19 A Yes. It's calculated by taking
20 the market shares of the participants and
21 taking the square of those market shares and
22 then summing it up.

1 Q So, if you have one participant in
2 a market, the HHI would be 10,000, which is
3 100 squared. Right?
4 A Correct.
5 Q Now, if you have an atomistic
6 market where each company has a small
7 fractional share of the market, the HHI
8 actually approaches zero. Right?
9 A That's mathematically right, yes.
10 Q So, that's your range. You go
11 from zero to 10,000. Right?
12 A Close to zero to 10,000, yes.
13 Q Approaching zero. Would it be
14 correct to say epsilon to 10,000?
15 A Epsilon, I like that. Yes.
16 Q Now, just to give the panel a
17 sense of how the HHI scale works, if you have
18 two companies in a market and each had a 50
19 percent market share, the HHI would be 5,000.
20 Right?
21 A Right.
22 Q That would be 50 times 50, which

1 is 2,500, twice. You have to double it.
2 Right?
3 A Correct.
4 Q Because there's two firms?
5 A Yes.
6 Q And if you had four companies,
7 each with a 25 percent market share, the HHI
8 would be 2,500. Right? 25 squared is 1,250,
9 I believe.
10 A Good, I'm glad you're doing the
11 math for me.
12 Q Well, I'm going to ask you to do
13 some math in a second, so --
14 A Oh, okay. Well, I didn't bring my
15 calculator but I'm ready.
16 Q But would you agree that at four
17 firms --
18 A Four firms, 25 times 25 times 4.
19 So, 2,500.
20 Q Okay. And you would agree, would
21 you not that both the DOJ, or the DOJ and the
22 FTC, in the merger guidelines, divide the

1 spectrum of market concentration as measured
2 by the HHI into three regions that they
3 broadly characterize as unconcentrated,
4 moderately concentrated, and highly
5 concentrated. Correct?
6 A That sounds right. I don't
7 remember the exact terminology. I'll take
8 your word for it.
9 Q And it sets the ranges for those -
10 - well, rather than play guessing games, why
11 don't we pass out the merger guidelines so
12 that you can look at it.
13 MR. HANDZO: If I can just
14 interpose an objection to try and move this
15 along? Some amount of cross-examination on
16 his assumptions is certainly fair but I would
17 submit that we are well beyond the scope of
18 direct at this point.
19 CHIEF JUDGE SLEDGE: Mr. Joseph?
20 MR. JOSEPH: Your Honor, the
21 fundamental conclusion was that, of his direct
22 testimony and on which his entire presentation

1 has to be based, is that the underlying market
2 that he uses as a benchmark, is workably
3 competitive or is a competitive marketplace.
4 Especially given the statutory standard in
5 this case, which is that the -- your job is to
6 find the price that would -- most willing
7 buyers would pay willing sellers in a
8 competitive market.
9 And he has testified that he
10 believed, on direct, that it was workably
11 competitive and that it was found to be so by
12 these anti-trust authorities.
13 It seems to me fundamental to
14 cross-examination to probe the basis for that
15 conclusion, the basis for that understanding,
16 what he relied upon, and indeed whether or not
17 his reliance on the idea that his benchmark
18 market is a workably competitive or
19 competitive market that would be one that you
20 should give any credit to for the purpose of
21 deciding what a willing buyer would pay a
22 willing seller is fundamental to my cross-

1 examination.

2 CHIEF JUDGE SLEDGE: Why aren't

3 those legal arguments?

4 MR. JOSEPH: They are in part --

5 there's some legal argument but there's a lot

6 of foundation, including what this witness

7 relied on in reaching his conclusion with

8 respect to that marketplace.

9 MR. HANDZO: If I could just

10 respond, Your Honor? I think his fundamental

11 conclusion was that the CARP, last time, said

12 the willing sellers are the record companies

13 and that's what he used as his willing

14 sellers. Beyond that, I think we're getting

15 into the underpinnings of the original CARP

16 decision which I think is water long under the

17 bridge and I just don't see how, with all the

18 other issues we have to deal with, how we can

19 try an anti-trust case in the middle of this

20 case.

21 MR. JOSEPH: May I, Your Honor?

22 We're actually not getting into the

1 underpinnings of the prior decision. He said,
2 the witness has testified, that he relied on
3 these merger approvals for the competitive
4 nature of his benchmark and that he didn't
5 rely -- he relied on the underlying CARP to
6 define the market, but the question of whether
7 or not that market is competitive and whether
8 he was reasonable in relying on it, goes to
9 the nature of his analysis, the validity of
10 his analysis.
11 CHIEF JUDGE SLEDGE: All right.
12 The objection is overruled.
13 BY MR. JOSEPH:
14 Q Dr. Pelcovits, I've just handed
15 you a document marked as Services Exhibit 64.
16 Have you seen that document before?
17 A I have.
18 Q And that is the Justice
19 Department, FTC merger guidelines. Correct?
20 A It is.
21 (Whereupon, the document
22 referred to as Services

1 Exhibit No. 64 was marked
2 for identification.)
3 BY MR. JOSEPH:
4 Q I would ask you, please to since
5 we were talking about ranges, I would ask you
6 please to turn to page 15 of the guidelines,
7 where the ranges of unconcentrated, moderately
8 concentrated and highly concentrated are set
9 out. Correct?
10 A Yes.
11 Q Okay. And it's correct, is it
12 not, that the guidelines identify an
13 unconcentrated market as below 1,000,
14 moderately concentrated between 1,000 and
15 1,800 and highly concentrated as an HHI above
16 1,800. Correct?
17 A Yes.
18 Q Now, do you know what the sound
19 recording industry's HHI is after the Sony-BMG
20 merger? Have you calculated it?
21 A I haven't. It's in the range of
22 -- I don't know. I'd say it's close, it's in

1 the range of 2,000 or so. It might be a
2 little lower, it might be a little higher. If
3 you had five firms each with 20 percent market
4 share, you'd get that number. So, here you
5 have some firms a little bigger and you have
6 many other firms, though I haven't calculated
7 the exact number.
8 Q Let me hand you a document that
9 may facilitate the math. Give one to opposing
10 counsel, okay? Now, I'm handing out -- I'm
11 sorry --
12 I've handed out a document that
13 was produced under the protective order by
14 Universal, one of the major labels and we'll
15 see whether, let me see whether the
16 examination is one that we can do without
17 requiring any motion for restriction. If you
18 would turn to -- and these are excerpts from
19 a PowerPoint presentation that we will have
20 described in greater detail when Mr. Kenswil
21 takes the stand, Your Honor.
22 (Whereupon, the document

1 referred to as Services
2 Exhibit No. 65 was marked
3 for identification.)
4 BY MR. JOSEPH:
5 Q But if you turn to the page that's
6 marked SX76616, there is a graph there, Dr.
7 Pelcovits, marked U.S. Nielsen SoundScan total
8 out in market share first half of 2005 and it
9 gives market shares for each of the four major
10 labels. Just for the purpose of getting a
11 rough number, I'd ask you to assume that those
12 market shares are accurate and ask you whether
13 it's not correct that the HHI for the
14 recording industry, based on those market
15 shares, is approximately 2,200? You can do
16 the math or --
17 A I can do the math or say, yes. Or
18 we could --
19 Q Well, -- I'm sorry.
20 A It's going to be in that range. I
21 can see that simply from the first two
22 calculations, yet.

1 Q So, about 2,200, you agree?
2 A That makes sense to me.
3 MR. JOSEPH: Your Honor, I can see
4 now we've approached 12:30. I'm going to
5 start on an additional line in this same area,
6 but it will take some time. So, I'm, you
7 know, I would suggest that this is a good time
8 to break, if that's what Your Honor would
9 like.
10 CHIEF JUDGE SLEDGE: But you're
11 going to continue on this line of questioning
12 about what the -- about the analysis of
13 mergers --
14 MR. JOSEPH: I'm going to --
15 CHIEF JUDGE SLEDGE: -- in the
16 Justice Department?
17 MR. JOSEPH: And the Federal Trade
18 Commission and what they looked at. Yes, Your
19 Honor.
20 CHIEF JUDGE SLEDGE: All right.
21 We'll recess until 2:00.
22 (Whereupon, at 12:34 p.m., the above-

1 entitled matter recessed to reconvene at 2:03
2 p.m. the same day.)
3 CHIEF JUDGE SLEDGE: Thank you.
4 We'll come to order.
5 MR. HANDZO: Before we begin,
6 SoundExchange has filed its opposition to the
7 motion to strike Ms. Fink's testimony. I have
8 courtesy copies here, they've already been
9 distributed in the courtroom. If the Court
10 would like copies, I can give them to you now.
11 CHIEF JUDGE SLEDGE: Please.
12 Mr. Joseph?
13 MR. JOSEPH: Thank you, Your
14 Honor.
15 In an effort to expedite the
16 discussion of the merger approvals, what I'm
17 going to do is actually hand out, let me count
18 the number of documents, six documents that
19 have been marked and try to get a sense or an
20 understanding from the witness of what the
21 witness saw and relied on and what he didn't.
22 And I think that will help move things along.

1 BY MR. JOSEPH:
2 Q Okay now, Dr. Pelcovits, I have
3 handed you Services Exhibits 66, 67, 68, 69,
4 51, because that had already been shown to a
5 witness earlier in the case, and 70. I ask
6 you -- let's do them one at a time.
7 In reviewing the FTC and European
8 Commission approvals of the Sony-BMG merger,
9 did you review the document marked Services
10 Exhibit 66?
11 A I did.
12 (Whereupon, the document
13 referred to as Services
14 Exhibit No. 66 was marked
15 for identification.)
16 BY MR. JOSEPH:
17 Q Okay. Did you review the document
18 marked Services Exhibit 67?
19 A Yes.
20 (Whereupon, the document
21 referred to as Services
22 Exhibit No. 67 was marked

1 for identification.)
2 BY MR. JOSEPH:
3 Q Did you review the document marked
4 68?
5 A I don't recall reviewing each
6 letter, but it's the same letter. So, I
7 remember reviewing the letter.
8 (Whereupon, the document
9 referred to as Services
10 Exhibit No. 68 was marked
11 for identification.)
12 BY MR. JOSEPH:
13 Q Did you review the document marked
14 Services Exhibit 69?
15 A Yes.
16 (Whereupon, the document
17 referred to as Services
18 Exhibit No. 69 was marked
19 for identification.)
20 BY MR. JOSEPH:
21 Q Okay. Were these the FTC
22 documents you were referring to when you said

1 you reviewed the FTC discussion of the Sony-
2 BMG merger and that you relied on in reaching,
3 in part, in reaching your conclusion?
4 A I relied on these as evidence that
5 the FTC did not block the merger and I
6 inferred, based on my knowledge of merger
7 practice and approval practice that, as I said
8 in my testimony, that the industry and the
9 firms don't have a monopoly power.
10 MR. JOSEPH: I would offer
11 documents, Services Exhibits 66, 67, 68, and
12 69 on that basis.
13 CHIEF JUDGE SLEDGE: Any
14 objections to 66, 67, 68, and 69?
15 MR. HANDZO: No, Your Honor.
16 CHIEF JUDGE SLEDGE: No objection.
17 Each of these exhibits is admitted.
18 (Whereupon, the documents
19 marked as Services
20 Exhibits No. 66 through
21 69 for identification
22 were received

1 into evidence.)
2 BY MR. JOSEPH:
3 Q Now I ask you, Dr. Pelcovits, to
4 take a look at Exhibit 51, which purports to
5 be the European Commission Order or Discussion
6 -- Decision in the merger case. Did you
7 review this document, and is that part of what
8 you relied upon?
9 A Yes.
10 MR. JOSEPH: I would offer Exhibit
11 51.
12 CHIEF JUDGE SLEDGE: Any
13 objections to Exhibit 51?
14 MR. HANDZO: No.
15 CHIEF JUDGE SLEDGE: Without
16 objection, Exhibit 51 is admitted.
17 (Whereupon, the document
18 marked as Services
19 Exhibit No. 51 for
20 identification was
21 received into evidence.)
22 BY MR. JOSEPH:

1 Q And I would ask you to look at
2 Services Exhibit 70, Dr. Pelcovits. This
3 appears to be an article by a Susan Manning
4 and Helen -- Eileen Reed that, among other
5 things, on page 8669 discusses the merger and
6 it was identified in an inter -- excuse me.
7 Withdraw that.
8 This purports to be an article by
9 Ms. Reed and Manning that on page 8669
10 discusses the Sony-BMG merger and it was
11 identified in an interrogatory response as a
12 document that you reviewed in connection with
13 the merger by SoundExchange. Have you seen
14 this article?
15 A I have. I think it actually
16 starts on 8668 and continues to 8669.
17 (Whereupon, the document
18 referred to as Services
19 Exhibit No. 70 was marked
20 for identification.)
21 Q That's fine.
22 MR. JOSEPH: And I would offer

1 this document, as well.
2 CHIEF JUDGE SLEDGE: Any objection
3 to Exhibit 70?
4 MR. HANDZO: No, Your Honor.
5 CHIEF JUDGE SLEDGE: Without
6 objection, Exhibit 70 is admitted.
7 (Whereupon, the document
8 referred marked for
9 identification as
10 Services Exhibit No. 70
11 was received
12 into evidence.)
13 BY MR. JOSEPH:
14 Q Now, I would ask you, Dr.
15 Pelcovits, take a look at document 69, which
16 is the statement of Commissioner Thompson in
17 connection with the merger. Among other
18 things, at the top of the second paragraph,
19 Commissioner Thompson notes the history of
20 facilitating practices, is the word he uses.
21 Can you tell us what facilitating practices
22 are?

1 A Generally, that's a term used to
2 describe practices that enable or facilitate
3 the practice of coordinated behavior among
4 firms in an industry.
5 Q And he also refers to practices
6 referring -- ranging from alleged anti-
7 competitive minimum advertising price programs
8 to agreements to fixed prices unlimited
9 advertising. Let me ask you if you are
10 familiar with the alleged anti-competitive
11 minimum advertised price program that
12 Commissioner Thompson is referring to?
13 A I might have reviewed it at one
14 point, I don't recall it at this point.
15 Q Well, let me see if we can refresh
16 your recollection.
17 Do you recall reviewing this
18 document or a document about the subject
19 matter discussed in this document in
20 connection with your review of the sound
21 recording industry?
22 (Whereupon, the document

1 referred to as Services
2 Exhibit No. 71 was marked
3 for identification.)
4 A I do not recall reviewing this.
5 Q You don't. Do you recall the
6 subject matter?
7 A If you give me a minute, please?
8 Q Sure. Take your time.
9 A Does this have a date on it for
10 the --
11 Q I believe the only date that it
12 has on it is the web, the URL date, which
13 shows September 2000 or 2000/09.
14 A Okay. Thank you.
15 I'm sorry, is the question did I,
16 have I relied on this and reviewed this?
17 Q Have you reviewed that document in
18 connection with your review of the recording
19 industries?
20 A I have not.
21 Q Were you aware when you considered
22 whether or not the sound recording industry

1 was workably competitive that the Federal
2 Trade Commission had filed a complaint in
3 September of 2000 against the major record
4 companies after finding, among other things,
5 that they had engaged in anti-competitive
6 conduct facilitating horizontal collusion in
7 connection with the sale of CDs?
8 A I was not aware of this specific
9 proceeding. I am aware that there have been
10 a variety of anti-trust investigations of the
11 record industry.
12 Q When you say anti-trust
13 investigations, as one who has experience in
14 anti-trust matters, is it your understanding
15 that the issuance of a complaint and the
16 acceptance of a consent decree is the same as
17 simply an investigation when its pursued by
18 the FTC?
19 A No.
20 Q And what's the difference?
21 A Consent decree is the resolution
22 of a complaint. So, it obviously is a -- I

1 would say it provides more basis for believing
2 that the issues raised in the complaint are,
3 have some higher probability of being proven
4 than those where there's purely a complaint
5 without a consent decree.
6 Q It is true, is it not, that the
7 FTC won't issue a complaint unless they find
8 reason to believe that violations of the anti-
9 trust laws have occurred. Correct?
10 A I don't know whether that's their
11 operating standard, whether it's a reason to
12 believe basis or -- I'm not sure.
13 Q You don't know their operating
14 standard?
15 A Not for issuing a complaint, I
16 don't know what the operating standard is.
17 Q By the way, turning back to the
18 letters, Exhibits 67 and 68, to understand
19 formally what the FTC did, it would be correct
20 to say that it decided not to take enforcement
21 action. Correct?
22 A That is the formal declaration and

1 that is essentially the same, it has the same
2 effect as a finding that the merger does not
3 violate anti-trust law.
4 Q Well it's true, is it not, sir,
5 that the letter says this action is not to be
6 construed as a determination that a violation
7 may not have occurred?
8 A That's what it says.
9 Q Now with respect to the European
10 Commission Decision you said you reviewed, did
11 you consider that decision to be a reliable
12 discussion of the relevant markets related to
13 the sound recording industry?
14 A I considered their finding and
15 their approval of the merger as supportive of
16 the statement that I made in testimony and
17 deposition that the recording industry is
18 workably competitive. That's the degree to
19 which I relied on it.
20 Q Did you examine the specific
21 discussion of the online music market?
22 A I do recall a discussion in the

1 decision on that.
2 Q More than -- well, let me hear
3 what my question was again, please.
4 (Question read back.)
5 BY MR. JOSEPH:
6 Q And did you examine that
7 discussion --
8 A I wasn't able to hear it, could
9 you please repeat it?
10 Q Well, let me just ask a question.
11 Did you examine and rely on the discussion of
12 the online music market in forming your
13 opinion that the industry was workably
14 competitive?
15 A Not specifically, no.
16 Q By the way, do you have an
17 understanding of the laws governing European
18 Commission review of mergers, generally?
19 A I have a -- I can't say that I can
20 recall the exact wording of the laws, but I've
21 lived through merger approval processes in
22 Europe, been there, sat through proceedings --

1 Q Would you -- sorry.
2 A So, I've had -- I know it from
3 experience, not from reading the law.
4 Q And is it your understanding that
5 the laws of the European Union impose very
6 specific requirements on the commission before
7 it can successfully challenge a merger?
8 A I don't recall specific
9 requirements. I recall, from experience, the
10 nature of the way they proceed and how they
11 look at anti-trust issues. And I'd say it's
12 comparable, if not more aggressive than the
13 U.S. anti-trust authorities.
14 Q Is it your understanding that the
15 Commission has to develop a cogent and
16 consistent body of evidence that supports each
17 of several specific elements in order to
18 challenge a merger?
19 A I did not recall that's the exact
20 standard.
21 Q Do you know whether or not the
22 burden of proof is on the Commission or on the

1 merging parties in a European Commission
2 proceeding challenging a merger?
3 A I believe it's on the Commission
4 to prove it.
5 Q By the way, just so when the Board
6 looks at this decision, could you please turn
7 to page 73 -- I'm sorry, paragraph 73 on page
8 25. And the Commission speaks about examining
9 whether any price coordination on the basis of
10 a parallelism in average prices could have
11 been reached using certain list prices. Can
12 you tell -- do you have an understanding of
13 what the term parallelism means in this
14 context?
15 A I don't recall specifically what
16 they're referring to. I'd have to go back and
17 reread more of the decision.
18 Q Do you have a general
19 understanding in the context of anti-trust
20 analysis what the term pricing parallelism, or
21 what the term parallelism in connection with
22 prices means?

1 A Well, I assume it's -- I mean,
2 what I would expect is it's referring to price
3 coordination because that's modifying the
4 first part of the sentence. The Commission
5 examined whether any price coordination.
6 There are various ways of looking at price
7 coordination. You can be looking at the
8 actual data on the prices and one part of the
9 examination is whether the prices are the same
10 over time for the firms that are alleged to be
11 coordinating prices. I assume that's what
12 it's referring to. Exactly how they use there
13 and what they said about it, I don't recall.
14 MR. JOSEPH: And, Your Honor,
15 we're actually on page 25, paragraph 73.
16 BY MR. JOSEPH: Q.And in the next
17 sentence, there's a reference to the term to
18 determine whether certain discounts were
19 sufficiently transparent in order to allow
20 sufficient monitoring of any price
21 coordination. Do you have an understanding of
22 what the term transparent means when it's used

1 in that context?
2 A Yes. I think that that's
3 referring to whether the discounts being
4 granted by firm A are known to firm B, so that
5 they can see what the prices, the effect of
6 prices in the market. I can expand if you
7 want me to.
8 Q No, I think that's fine. That's a
9 good basic concept.
10 Are you aware, Dr. Pelcovits, that
11 in its decision, the European Commission
12 determined that the market for online music
13 licenses from the record companies was a
14 distinct market that deserved analysis?
15 A Yes, they said that. And I will
16 just add they said that there were to be exact
17 elimination of markets can be left open, the
18 competitive assessment is the same under any
19 market definition considered. Paragraph 29.
20 Q Is it not true, Dr. Pelcovits,
21 that that statement actually referred to the
22 question of whether online downloading and

1 streaming were part of the same market for
2 distribution of online music or whether they
3 formed separate markets?
4 A Yes.
5 Q So that doesn't go to the question
6 of whether the markets for wholesale licenses
7 for online distribution is itself a market,
8 does it?
9 A Not directly. I think it goes to
10 the general point of careful delineation of
11 these markets is not always the most important
12 part of an anti-trust investigation.
13 Q But, in this case, if you turn to
14 paragraph 24 on page 8, it's true, is it not
15 that the Commission considered online music is
16 not part of the market for physical recorded
17 music and two different markets must, their
18 words must, be distinguished, one of which was
19 the wholesale market for licenses of online
20 music. Correct?
21 A Yes, correct.
22 Q That's what they found in the

1 Sony-BMG case. Correct?
2 A That's correct.
3 Q Now let me ask you to turn to page
4 6 of your report -- or I should say, of your
5 written direct testimony.
6 A I have it. Thank you.
7 Q In the only full paragraph on the
8 page, six lines up from the bottom, you say,
9 and this is in -- well, you say that if the
10 price is too high and, in context, I take it
11 that's the price set by this Board or by the
12 prior CARP. Correct?
13 A Correct.
14 Q Parties can (and indeed are almost
15 certain to) negotiate agreements for rates
16 lower than the statutory standard. That was
17 your testimony. Correct?
18 A Correct.
19 Q Now, you wouldn't expect the same
20 effect in a market where the sellers sit
21 together and plan a common strategy for
22 pricing in the market, would you?

1 A Well, that would, that would
2 depend on the specific circumstances.
3 Q Well, if the sellers can be
4 affective at maintaining discipline among
5 themselves, you wouldn't expect that same
6 result to obtain, would you?
7 A It still might.
8 Q But you would expect a different
9 outcome, wouldn't you?
10 A A different than if there was not
11 a perfect discipline among the parties. There
12 would still be an issue whether the industry
13 as a whole would get more revenue by lowering
14 prices. It might still be the same prices
15 but, if by lowering prices you were to
16 increase demand sufficiently to offset the
17 reduced margin, that would still be a
18 profitable strategy. And my sense is that,
19 again, we're dealing with an industry where
20 price competition among the different titles
21 of records does not seem to be an important
22 competitive variable.

1 Q Dr. Pelcovits, do you remember
2 when I asked you essentially those same
3 questions at your deposition?
4 A I remember the general topic.
5 Thank you.
6 (Whereupon, the document
7 referred to as Services
8 Exhibit No. 72 was marked
9 for identification.)
10 BY MR. JOSEPH:
11 Q Let's see what your answer was
12 when I asked you then. Would you please turn
13 to page 71 or pages 71 and 72. It's actually
14 on page 19 of the four --
15 A Oh.
16 Q This format puts four deposition
17 pages together on a page.
18 A I'm sorry, page 70?
19 Q 71.
20 A 71.
21 Q It starts on line 24 --
22 A Okay.

1 Q -- where I ask, would you expect
2 the same effect to apply in a market where the
3 sellers sit together to plan a common strategy
4 for pricing in the market. And you said that
5 if you were in a situation whereas you posited
6 in the question, the sellers are sitting
7 together to set prices, as a general matter,
8 if they can be affective at maintaining
9 discipline among yourselves, you're going to
10 get a different outcome than if they act
11 independently. It's just the nature of
12 cartels versus competition.
13 That was your answer then.
14 Correct?
15 A Yes.
16 Q And that's an accurate answer?
17 A Yes.
18 Q By the way, let me ask you to
19 assume hypothetically that the members of such
20 a group that was coordinating pricing knew
21 that any agreement that they entered into
22 below the price that they were trying to reach

1 would become through discovery in a legal
2 proceeding and would be useful as evidence
3 against the goals of setting the common price,
4 that would be a strong disincentive to
5 undercutting the price, wouldn't it?
6 A I suppose it's possible.
7 Q Okay, Dr. Pelcovits, let's turn to
8 page -- it's your written report and I would
9 ask if it's correct from page 30 to page 42 of
10 the report where you described how you derived
11 your recommendation for a per subscriber fee
12 for the sound recording license in the non-
13 interactive, in the target market, from the
14 per subscriber fee for the sound recording
15 license in the benchmark market?
16 A Yes.
17 Q And I believe, when you were
18 talking with Mr. Steinthal earlier, you
19 testified that the assumption that the ratio
20 of the consumer price to the royalty rate
21 would be the same in both the target and the
22 benchmark markets was a key to your analysis.

1 Correct?
2 A Yes.
3 Q And I believe you said, on direct,
4 that you believed that that assumption was
5 correct because you believed the demand
6 elasticity in both markets was likely to be
7 similar. Correct?
8 A Correct.
9 Q Okay. And just so the record is
10 clear, the demand elasticity is the
11 sensitivity of demand to changes in price.
12 Correct?
13 A Quantity and demand --
14 Q As a general statement?
15 A -- is the change in percentage --
16 change in the quantity of demand with respect
17 to a percentage change in the price.
18 Q Which is the numerator, which is
19 the denominator, the percentage change in
20 quantity or the percentage change in price?
21 A The numerator is the quantity, the
22 denominator is the price. So, I think high

1 elasticity means that there's a large quantity
2 change in respect to a small price change.
3 Just so we have the math right, we talk about
4 this in absolute value terms because actually
5 the number is negative. But conventionally,
6 because price -- as price goes down quantity
7 goes up but the convention is to say larger,
8 smaller, even though we're dealing with a
9 negative number.
10 Q Thank you.
11 A I just didn't want to get that
12 confused.
13 Q So now let's turn to page 33 of
14 your written statement and look at figure one.
15 This figure describes graphically your
16 discussion of the relationship between the
17 license fee for sound recording rights paid by
18 music services to the retail subscription fee
19 paid by consumers. Correct?
20 A Yes, it's illustrating that
21 relationship.
22 Q Now, your written statement on

1 pages 32 and 33 calls the line marked DMS, the
2 demand curve for the interactive music
3 services. Right?
4 A Correct.
5 Q But that's not strictly speaking
6 what that line is, is it?
7 A If we're trying to capture what's
8 going on in the market, no, it's not strictly
9 speaking. Correct.
10 Q In fact, you intend the demand
11 curve, line DMS, to be a demand curve facing
12 a single music service. Correct?
13 A I know I said that on deposition.
14 I have to remember now whether it makes a
15 difference whether it's a single music service
16 or whether it's the music service business as
17 a whole. I don't think it matters.
18 Q Well, to be more accurate, didn't
19 you describe it -- or is it not, the demand
20 curve, is it not your testimony that it's the
21 demand curve faced by a single music service
22 with respect to the sound recordings of a

1 single record company?
2 A Right. That part is correct.
3 It's with respect to the sound recordings of
4 a particular record company.
5 Q Now, the line marked DD you intend
6 to be the derived demand of the service for
7 the sound recording input from a single record
8 company. Is that correct?
9 A That's correct.
10 Q And if that's true, then the point
11 P would represent the portion of a license fee
12 for a music service represented by the sound
13 recordings of a single record company.
14 Wouldn't it?
15 A Yes.
16 Q And the point F would represent
17 the license fee paid by the music service to
18 a single record company. Correct?
19 A Correct.
20 Q When you -- is there anywhere in
21 your written testimony that you actually
22 explained the meaning of those lines in terms

1 of a single record company?
2 A No.
3 Q And, in fact, on pages 35 and 36,
4 you describe the points P and F quite
5 differently than you've just described them in
6 this testimony, don't you?
7 A I apply them differently than how
8 I described them earlier. I think we went
9 through this in deposition and I distinguished
10 what I was trying to sort of provide by way of
11 explanation and just the graph and what I
12 eventually did and how I applied it.
13 Q Well, if you would look with me,
14 please, on page 36, in the paragraph at the
15 bottom of the page, second sentence, you're
16 saying as show in table one of Appendix A,
17 which is your list of the contracts, the
18 average per subscriber fee for copyright in
19 the interactive market is $2.97, corresponding
20 to F on figure one. That's what you said in
21 your testimony. Right?
22 A Correct.

1 Q But that's not in fact what point
2 F represents, is it?
3 A That's not what F represents in
4 the picture, in the graph on page 33 and the
5 economics of this still holds. And I was
6 trying to make it clear. I, obviously, made
7 it less clear.
8 Q And you didn't tell the Board that
9 actually the graph didn't represent what you
10 said it represented on page 36, did you?
11 A I have not amended testimony.
12 That's correct.
13 Q Let's turn to page 34 of your
14 written testimony. You say that the distance
15 -- excuse me one second.
16 The last full sentence in the
17 text, not in the footnotes, you say the
18 distance between the two demand curves is the
19 amount that would cover the other production
20 costs of the music services including a
21 reasonable profit margin. Correct?
22 A Correct.

1 Q Now, when you say the two demand
2 curves, you're referring to the demand for the
3 service and the derived demand for the
4 license. Correct?
5 A Correct.
6 Q And those were the lines DMS,
7 which is the demand for the service, and DD,
8 which is the demand for the license. Correct?
9 A Correct.
10 Q And when you say the other
11 production costs, you're referring to the
12 production costs other than the sound
13 recording license. Correct?
14 A Correct.
15 Q And you don't have any reason to
16 believe that the production costs, plus a
17 reasonable profit margin for non-interactive
18 digital music services are any less than the
19 production costs and a reasonable profit
20 margin for interactive music services. Do
21 you?
22 A I do not.

1 Q And so, if that's true, you would
2 expect the distance between the demand curve
3 facing the music service and the derived
4 demand curve of the music services for
5 licenses to be the same for interactive and
6 non-interactive services. Correct?
7 A Yes.
8 Q Now, on page 34, you say that
9 you've drawn the derived demand curve for
10 sound recordings to be parallel to the demand
11 curve for the music service. Correct?
12 A Correct.
13 Q And you actually give two reasons
14 for doing that. Correct?
15 A Yes.
16 Q Okay. So, let's consider the
17 combined significance of your assumptions.
18 The distance between the derived demand curve
19 and the service demand curve is equal to
20 production costs plus a reasonable profit.
21 There's no reason to believe that the
22 production costs plus a reasonable profit for

1 the interactive services and the non-
2 interactive services differ and the derived
3 demand curve and demand curves are parallel to
4 each other in both markets. Assuming, as your
5 evidence shows, that the consumer subscription
6 fee for non-interactive services are
7 significantly lower than the consumer
8 subscription fee for interactive services,
9 isn't it true that the ration of the license
10 fee to the subscription fee for non-
11 interactive services must be significantly
12 lower than the ratio of the license fee to the
13 subscription fee for the interactive services?
14 A As we stand today, or as the
15 evidence in the market is today with the
16 statutory rate, yes.
17 Q I'm not asking about as we stand
18 with the statutory rate. I'm asking, based on
19 the assumptions as you have made them in the
20 market and your use of the benchmark and
21 target markets?
22 A I think I'm confused about the

1 question then.
2 Q When you talk about the derived
3 demand curve and the service demand curve for
4 the interactive market and the non-interactive
5 markets, you're not talking, when you're
6 talking about the non-interactive market,
7 about the market that we find under the
8 statutory license, you're talking about your
9 hypothetical target market, aren't you?
10 A Well, if I'm observing prices
11 today, which is, if you're asking what is the
12 relationship between the license fee and the
13 retail price for interactive services, what's
14 in the market today does not represent what
15 would occur if the license fee I'm proposing
16 were adopted.
17 Q Well, let me ask the question with
18 -- you're taking your same three assumptions.
19 If you assume that the consumer subscription
20 fee for non-interactive services are
21 significantly lower than the consumer
22 subscription fee for interactive services,

1 isn't it true that the ratio of the license
2 fee to the subscription fee for non-
3 interactive services must be significantly
4 lower than the ratio of the license fee to the
5 subscription fee for interactive services?
6 A Yes.
7 Q Let's take an example using rough
8 numbers. Let's assume that in the interactive
9 market, the average per subscriber license fee
10 is $3 and the average consumer subscription
11 fee is $8. That leaves imputed production
12 costs plus a reasonable profit of $5. Right?
13 A Right.
14 Q Let's assume in the non-
15 interactive market, the average subscription
16 fee is $6, where these are all per month
17 numbers, as you've used throughout, if you
18 assume that the same production costs plus a
19 reasonable profit apply in the non-interactive
20 market and that's the same $5, isn't it true
21 that the appropriate license fee indicated by
22 the non-interactive transmission service

1 derived demand curve would be $6 minus the $5
2 or $1?
3 A No.
4 Q And why not?
5 A You're assuming that prices --
6 you're taking evidence from what prices are
7 right now and saying what the fee should be
8 without allowing the market to adjust for the
9 higher fee.
10 Q I wasn't taking any evidence. I
11 was asking you to assume average subscription
12 fees. Are you saying that under your model
13 the subscription fee for the non-interactive
14 services would exceed the subscription fee for
15 the interactive services?
16 A No.
17 Q So, they're going to be less?
18 A It depends on demand. I expect
19 that it would be less, yes. They are less
20 now. I'd expect them to continue to be less.
21 Q Well, didn't your model actually
22 rely on the subscription fees that you

1 observed in the marketplace?
2 A In order to measure the value to
3 consumers of interactivity or the difference
4 in value between an interactive and non-
5 interactive.
6 Q Isn't that exactly what I was
7 doing when I was taking the assumption that
8 the subscription fees -- let me rephrase.
9 Isn't that exactly what I was
10 doing when I was taking the assumption that
11 the price charged to consumers for
12 subscription services was $8 and the price
13 charged to consumers for non-subscription
14 services was $6? I was just doing the same
15 kind of analysis you were with round numbers.
16 A No, you weren't.
17 Q How was I doing something
18 different?
19 A You were getting a rate based on
20 existing prices in the market. And the
21 existing prices in the non-interactive market
22 are a function of the rate that was set by the

1 prior CARP. And the relationship between the
2 fee and the price in the market is, again,
3 driven by the existing CARP set rate.
4 Q Was it valid for you, when you
5 looked at the price consumers were willing to
6 pay in the marketplace, to look at the average
7 prices paid by consumers for non-interactive
8 services?
9 A Yes.
10 Q And when you did that, you found a
11 number. Correct?
12 A Yes.
13 Q And if you subtract from that
14 number that you found the same reasonable --
15 I'm sorry -- the same production cost plus a
16 reasonable profit number that you found to
17 exist in the interactive services market,
18 isn't it true that you would actually come out
19 with a negative fee?
20 A Yes.
21 Q Now on page 34, Dr. Pelcovits, in
22 your assumption that the demand, the derived

1 demand curves are parallel, you gave two
2 reasons I think I mentioned earlier. First,
3 you said that sound recordings are a non-
4 substitutable input and second, you said that
5 you assumed that any change in the copyright
6 fee -- I'll withdraw this question actually.
7 I'm sorry.
8 On page 36 of your testimony you
9 state that it's reasonable to assume that the
10 demand elasticities in the interactive and
11 non-interactive markets would be very close.
12 That's been talked about before. But it's
13 true, is it not, that the availability of
14 different substitutes for the two different
15 kinds of services could lead to different
16 demand elasticities in their respective
17 markets?
18 A Yes.
19 Q And other than what you've
20 described in footnote 14, you did not perform
21 any analysis of the demand elasticity in
22 either the benchmark or the target market, did

1 you?
2 A Correct.
3 Q And it's also true, is it not,
4 that the concept of elasticity of demand for
5 non-subscription services has a very different
6 meaning than the concept of elasticity of
7 demand for subscription services because the
8 customer is not paying the price in the non-
9 subscription model. Correct?
10 A It is a different market
11 elasticity. It doesn't mean the concept does
12 not apply.
13 Q Well, it's true, is it not, that
14 the term elasticity would have a very
15 different meaning?
16 A It would have a different
17 application. Can I say it's a different
18 meaning? If -- I would still say it's not a
19 different meaning. It's a different
20 application. That's quibbling over words, but
21 essentially, I think that's a better way to
22 put it.

1 Q Just to be clear, it's true, is it
2 not, that your analysis of the percentage of
3 revenue fee in the non-interactive market,
4 just as your analysis of the per subscriber
5 fee also depends on your assumption that the
6 ratio of the license fee to the subscription
7 price in the hypothetical non-interactive
8 market is the same as the ratio of the license
9 fee to the subscription price in the
10 interactive market?
11 A I was -- sorry. I was distracted
12 in the middle of the question. I apologize.
13 Q On page 42, if you -- make it
14 easier, I think, if you look at the third
15 sentence, fourth sentence.
16 If, as I have said, the ratio of
17 license fees to subscription price charged to
18 consumers is the same in the interactive and
19 non-interactive markets, the same percentage
20 of revenue fee would be charged in both
21 markets. I just want it to be clear that that
22 assumption is in fact a key assumption of your

1 analysis to derive the percentage of revenue
2 rate also, is it not?
3 A I'm a little confused exactly what
4 the question is different from what I've said
5 here. But I said that the same relationship
6 between subscription fees and subscription
7 prices follow, the logic follows through from
8 subscription fee recommendation through to the
9 revenue recommendation.
10 Q Let me ask my original question
11 again, and see if it's easier.
12 A I'm not trying to be difficult,
13 I'm just having a hard time --
14 Q I just want to ask if it's true
15 that your analysis of the percentage of
16 revenue fee, like your analysis of the per
17 subscriber fee, depends on your assumption
18 that the ratio of the license fee to the
19 subscription price in the target and the
20 benchmark markets is the same?
21 A Or should be the same, is what I
22 would say.

1 Q Let me ask you to look at pages
2 183 and 184 of your deposition. Page 47 of
3 the transcript that I've given you. Now,
4 turning to your --
5 I asked you, at your deposition,
6 turning to your varivation of the percentage
7 of revenue fee, is it true that that
8 determination also depends on the assumption
9 that the ratio of the license fee to the
10 subscription price in the NI-DAT market is the
11 same as in the I-DAT market? And you said,
12 yes, although to clarify, it's not that it is
13 right now, but that it would be in a market
14 without a statutorily set fee.
15 Is that a correct answer?
16 A That's correct.
17 Q Okay.
18 A That's exactly what I tried to say
19 a minute ago.
20 Q Okay. And on page -- let's see.
21 Turn now to page 43 of your written testimony.
22 You state that it's your understanding that

1 under the interactive DAT contracts, under the
2 structure of the agreements that you reviewed,
3 payments are usually not made on the basis of
4 a per play rate. Correct?
5 A I recall saying that. I don't see
6 where you're pointing me to.
7 Q Okay.
8 UNIDENTIFIED SPEAKER: It's in the
9 written testimony.
10 BY MR. JOSEPH:
11 Q Oh, it's in the written testimony.
12 I'm sorry.
13 A Okay. So, I'm sorry, what page?
14 Q 43.
15 A Okay, thanks. Yes. Now, I see
16 exactly what you're referring to and yes,
17 that's what I said.
18 Q What was the source of your
19 information for that statement?
20 A The source is the testimonies of
21 the record company witnesses that I list at
22 the bottom of the paragraph.

1 Q Did you actually review the
2 payment history under the interactive
3 agreements?
4 A No.
5 Q Let me ask you to turn to page 8
6 of your testimony, written testimony. And
7 there you say that, toward the bottom, one of
8 the reasons to use your benchmark market, is
9 that there are "statistically meaningful
10 data?"
11 A Yes, sir.
12 Q And on page 12 of your testimony
13 you say that information of prices in the
14 candidate market, and I take it by that you
15 mean candidate market to be a benchmark, --
16 A Correct.
17 Q -- must be available and
18 statistically valid.
19 A Yes.
20 Q Correct? Now, by statistically
21 valid and meaningful, you mean, do you not,
22 that the dispersion of the data is relatively

1 small, as measured by such measures as
2 variants or standard deviation?
3 A I think I mean more than that. I
4 think it means that the data is clearly
5 representing the nature of marketplace
6 transactions. And, I would say also it has
7 good statistical properties that to the extent
8 that there is variation, it's either
9 explainable or it's not so great as to make
10 any statistical inferences invalid.
11 Q But one of the conditions of
12 statistically meaningful or statistically
13 valid data is that the data are -- that the
14 dispersion of the data is relatively small, as
15 measured by statistical measures. Correct?
16 A I might have put it that way at
17 one point, but I think it's better to say that
18 it's dispersion is explainable or not so
19 widespread that it makes the inferences
20 invalid. I'm just trying to be a little more
21 precise.
22 Q Well, let me ask you to look at

1 page 126 of your deposition, which is on page
2 33 of the transcript that you've got. And I
3 ask what you meant by statistically meaningful
4 data and you said then, primarily the
5 dispersion of data as measured by variant or
6 variants, I suspect is what you had said,
7 standard deviation or other measures is
8 relatively small, so you can assign pretty
9 high confidence to the averages or means.
10 Correct?
11 A Yes.
12 Q And that's what you meant, at
13 least, when I was taking your deposition.
14 Correct?
15 A I mean it know. I'm a little
16 fuller here in terms giving a broader
17 explanation.
18 Q Okay. It's possible, is it not,
19 that tightly grouped data in prices can be a
20 sign of parallelism and pricing of a kind that
21 can indicate anti-competitive behavior, isn't
22 it?

1 A It is possible.
2 Q And, Dr. Pelcovits, did you
3 perform any analysis of the probability that
4 in a competitive market where prices were set
5 wholly without reference to the other record
6 companies, every one but one of the 17
7 agreements that you looked at would have a per
8 play fee that was exactly the same?
9 A Is the question am I aware of
10 that? Yes.
11 Q No, my --
12 A I'm sorry.
13 Q -- question was, did you perform
14 any analysis of the probability --
15 A Oh, sorry.
16 Q -- that that would be so in a
17 competitive market where the prices are set
18 wholly without reference to other companies?
19 A I did not perform any analysis of
20 that. And I think, as I said, that that's
21 never the price actually paid. So, my sense
22 is it really is not telling you that much

1 about issues of parallelism of any sort or --
2 Q But it is the number that finds
3 its way into 16 of the 17 agreements, is it
4 not?
5 A Yes.
6 Q And in the other agreement, there
7 is no per play price. Correct?
8 A Correct.
9 Q Now, Dr. Pelcovits, I would ask
10 you to turn to page 48 of your written
11 statement. There you say that the claim that
12 radio promotes the sale of sound recordings
13 ignores the impact of radio on the amount of
14 time spent listening to recorded music.
15 Correct?
16 A Correct.
17 Q Did you examine quantitatively or
18 qualitatively the impact of radio listening on
19 the amount of time consumers spend listening
20 to recorded music?
21 A I did not do it. I read the
22 studies referred to here by Professor

1 Liebowitz. I did not conduct my own analysis.
2 Q You say the studies. In fact, you
3 read one paper there, correct?
4 A I cited one paper. He's written a
5 variety of papers. This is, I think, the
6 primary empirical piece that he's done.
7 Q Did you examine any information
8 about the amount of money that the record
9 companies spend to encourage radio stations to
10 play their recordings?
11 A I did not do any specific
12 analysis. I have read about that in various
13 depositions, transcripts. So, I understand
14 that there is an effort and an expenditure by
15 record companies to get and promote their
16 music at radio stations.
17 Q And you wouldn't expect record
18 companies to make those expenditures, if they
19 didn't believe those expenditures were
20 valuable to them, did you, would you?
21 A I would not.
22 Q Now, on page 49 of your written

1 testimony, you say that even if one were to
2 assume, and this is at the top of the second
3 full paragraph after third, that over-the-air
4 radio, overall, increased record sales. It's
5 an enormous unsupported leap to claim that
6 webcasting is promotional.
7 You didn't mean to say, in saying
8 that, that's it's an equally enormous leap to
9 say that internet simulcasts of radio
10 broadcasts to the same audience is
11 promotional, did you?
12 A I wouldn't say it would be to the
13 same degree a leap, the same size of a leap.
14 I think it's still something to be considered,
15 but it might not be the same if its customers
16 have a wider choice of stations to choose from
17 when they're on the internet.
18 Q That's not something you've
19 considered, though, and certainly wasn't
20 something you considered at the time of your
21 deposition, was it?
22 A That's -- I didn't consider it one

1 way or the other in this testimony.
2 Q Now, you refer to the Liebowitz
3 article. Do you recall that one of the
4 analysis Profession Liebowitz did, and I think
5 there were two empirical discussions in his
6 paper, was to review the paper surrounding the
7 introduction and growth of the radio industry
8 and its effect on the recording industry?
9 A That was one of two. The other
10 was looking at the UK where they started, for
11 the first time, to have a radio station that
12 broadcasts rock music, which was more recent.
13 But there were two studies, yes.
14 Q Let's talk about the first one
15 first.
16 A Sure.
17 Q The time period he reviewed
18 included the great depression, did it not?
19 A I recall, it's a long time ago, I
20 think it might very well have included that.
21 Q It included the introduction of
22 talking motion pictures, did it not?

1 A I expect it did, yes.
2 Q There were major differences in
3 the technology of that time than today, were
4 there not?
5 A I agree.
6 Q For example, the acoustic quality
7 of early radio was significantly better than
8 the acoustic quality of early sound
9 recordings. Do you remember him discussing
10 that?
11 A I do not recall that.
12 Q Do you remember that, in the days
13 he was looking at, sound recording lasted for
14 four minutes and then you had to flip the
15 side?
16 A I even remember those, those vinyl
17 records, yes.
18 Q And is it not true that Professor
19 Liebowitz himself says that the imprecision in
20 these data, the fluidity of the content and
21 technology, and the changing market
22 conditions, all make it impossible to have a

1 totally clear-cut test of the impact of radio
2 on the recording industry?
3 A I don't recall that, but I think
4 that's a reasonable statement, certainly for
5 the first study.
6 Q And the second study was performed
7 in Great Brittan, which you will agree is a
8 different country with a different culture?
9 A They are a different country with
10 a different culture but it's more recent and,
11 in fact, I thought it was a very nice of
12 empirical work to look at the UK.
13 Q And his conclusion, is it not, was
14 that the evidence for any effect is weak?
15 A Yes.
16 Q Now, Professor Liebowitz examined
17 the overall impact of radio on overall record
18 sales in his discussion, didn't he?
19 A Yes.
20 Q But from the standpoint of an
21 individual record company, its concern would
22 be with whether the airplay of its records

1 increased their sales. Correct?
2 A Whether the airplay of -- it could
3 really be two things. One, would lowering the
4 price of their licenses lead to increased play
5 and second, would increased play lead to
6 greater CD sales?
7 Q When we're talking about over-the-
8 air radio, we're not talking about the price
9 of licenses
10 are we?
11 A Correct.
12 Q Let me ask you to take a look at
13 page 49 to 50 of your testimony where you,
14 starting on page 49 at the bottom, you say
15 time spent listening to non-interactive
16 digital audio transmission services must be
17 coming from one of several alternative uses of
18 time, listening to CDs, listening to
19 interactive digital transmission services,
20 listening to terrestrial radio, or other
21 activities, e.g., watching TV. That's what
22 you said?

1 A Yes.
2 Q Aware you aware that a substantial
3 amount of the time spent listening to non-
4 interactive webcasting is in the office?
5 A Yes.
6 Q So, isn't it possible that a
7 substantial amount of time spent listening to
8 non-interactive webcasting is time that would
9 otherwise be spent listening to nothing, but
10 just working?
11 A I would say, again, the same type
12 of options would be there, such as listening
13 to interactive DATs or playing CDs or now we
14 have, you know, little MP3 players. So, there
15 are all sorts of options available at work, at
16 home.
17 Q Have you done any study or
18 analysis of the extent to which people play
19 CDs or listen to MP3 players in the office?
20 A I have not done any study, no.
21 Q Now, in your sensitivity analysis
22 of the affect of a decrease in CD purchases by

1 two, of a differential decrease in CD
2 purchases of two, you assume that he margin on
3 CDs is about $5.60. Correct?
4 A Correct.
5 Q Did that margin include the value
6 of the CD sale to the record company as well
7 as the recording artist, or just to the record
8 company?
9 A It included just to the record
10 company.
11 Q Did you consider whether
12 interactive services which consist of
13 downloads may substitute more for permanent
14 digital downloads than non-interactive
15 streaming services in addition to the greater
16 substitution effect on the sale of CDs that
17 you describe in your testimony?
18 A I did not consider that as a
19 separate affect the two CDs should be, in my
20 mind, considered as a differential whether
21 it's CDs or some combination of CDs and
22 digital downloads. So, it's some other

1 purchase of recorded music.
2 Q You would agree, would you not
3 though, that the margins made by the record
4 companies on digital downloads are greater
5 than the margins made in CD sales?
6 A On a percentage basis, they are
7 larger. On an album basis, they are maybe
8 about a dollar or so higher. And, overall,
9 whether there is a greater margin or not,
10 probably is influenced a lot by how many
11 tracks of an album a customer downloads. So
12 that if a customer downloads five tracks out
13 of an album, then the margin will be lower
14 from a digital download than buying a CD.
15 Q To your knowledge, did the $5.60
16 number that you used come from anything other
17 than the sale of physical CDs?
18 A It did not.
19 Q Now, at the bottom of page 51, you
20 say that in computing the price difference
21 caused by your assumed substitution difference
22 between interactive and non-interactive

1 markets, you assumed a linear demand curve.
2 Correct?
3 A Yes.
4 Q And, in fact, the resulting change
5 in price that's half the margin on the CD is
6 a direct result of that. Correct?
7 A Correct.
8 Q Did you perform any analysis to
9 determine the appropriate shape of the demand
10 curve?
11 A No.
12 Q In the regression analysis that
13 you spoke with Mr. Steinthal earlier, in
14 figure, in table 6.1 of your testimony on page
15 39, were there any radio simulcasting
16 services, by that I mean radio broadcasters
17 who simulcast their programming on the
18 internet, contained in that regression
19 analysis?
20 A Not as separate observations.
21 Some of them, some of the simulcasting is
22 carried by some of the pay services. So, only

1 indirect.

2 Q Do you know the extent to which

3 simulcasts were factored into this analysis?

4 A No. I can't measure that.

5 Q And you didn't take any pure

6 simulcasting services, did you?

7 A I did not take any pure simulcast

8 because there is no price to the consumer and

9 I based this on the price paid by the

10 consumer.

11 Q Is that another way of saying

12 simulcasters are non-subscription services?

13 A Yes, thank you.

14 Q In your regression analysis, one

15 of your variables, we can go back and look at

16 it if we need to, but I only have one more

17 question on it, so we'll see if we can --

18 MR. JOSEPH: -- on that, Your

19 Honor, not for the entire cross-examination.

20 BY MR. JOSEPH:

21 Q You had a variable marked quality

22 and you had a line, most of the services, in

1 fact as I recall and this is just a memory
2 test, all but one said high and one said
3 medium. Can you tell me the break point in
4 your analysis between high quality and medium
5 quality?
6 A I do not recall the breakpoint,
7 no.
8 Q Let me ask you to turn to page 12
9 of your testimony. In discussing the common
10 characteristics of the interactive and non-
11 interactive markets, your target and benchmark
12 markets, you identify, as a common
13 characteristic, the similarity of the buyers.
14 Are there any radio broadcasters in the
15 benchmark marketplace that you examined?
16 A There are none except, as I said
17 earlier, indirectly through the airage of
18 those stations by the subscription services.
19 Q And except to the extent that you
20 haven't quantified, and haven't attempted to
21 quantify, you are not aware of any radio
22 simulcasters that were direct purchasers in

1 the benchmark market, are you?
2 A Correct.
3 Q And there certainly were no radio
4 broadcasters in the 17 benchmark agreements
5 that you considered, were there?
6 A That's correct.
7 Q On page 14 of your testimony, you
8 say that music services that use the statutory
9 license often, I'm sorry, offer channels
10 targeted to particular generas, themes, or
11 subgeneras of music and that listeners can
12 select from among many subgeneras. Correct?
13 A Correct.
14 Q Now by genres, I take it, you mean
15 the dozen or so types of music that you see
16 categorized in Arbitron and other
17 publications?
18 A Yes.
19 Q And by subgeneras, you mean
20 subcategories of those genre?
21 A Yes.
22 Q Such as music specific to a time

1 period or a particular style?
2 A Yes, a style, time period, all
3 sorts of different ways of categorizing the
4 music that you see on these interactive
5 websites.
6 Q You did not examine, did you,
7 whether radio stations that simulcast their
8 programming typically provide narrow
9 subgeneras of music or more commonly provide
10 the broad genres such as those listed in
11 Arbitron and similar publications, did you?
12 A I am aware that radio stations, by
13 and large, are not as narrowly targeted as the
14 options available on the subscription
15 services.
16 Q On page 13 of your testimony, as
17 one of the similar experiences for the
18 consumer, you identify the ability, I'm sorry,
19 you identify the option to receive commercial
20 free service as important to your comparison
21 of that consumer experience for interactive
22 and non-interactive services. Correct?

1 A That's correct.
2 Q And, in fact, you believe whether
3 or not a service contained commercials in its
4 streams would be an important consideration
5 for consumers, don't you?
6 A I do.
7 Q You also believe that right now
8 it's very hard to assess or measure the
9 advertising market. Correct?
10 A I didn't say it's very hard to
11 assess it, I said that it's a very dynamic
12 market and there's -- I did not do an
13 assessment of the advertising market.
14 Q Let me ask you to look at page 202
15 of your deposition transcript, which is on
16 page 52 of the document you've got there. And
17 we were talking generally about the difference
18 between subscription services and advertising
19 services. And in your answer to my question
20 about how, let's see, how those services
21 differ, the differences change over time, you
22 said on line 14, we don't have evidence in the

1 market of what it's going to look like over
2 the entire next five years, so it's very hard
3 to assess or measure the advertising market
4 right now.
5 A Yes.
6 Q And you believed that when you
7 said it?
8 A I believe it now. Whether it's --
9 one way or another, I did not assess it. I
10 think it's hard to assess and measure. I
11 still believe that now.
12 Q On recommending a rate for non-
13 subscription services, does your analysis
14 consider how the music quality of those
15 services compare to the music quality of
16 subscription services?
17 A It does not. It does not set any
18 different in rate based on the quality of the
19 broadcast that the subscription or non-
20 subscription webcaster would use.
21 Q And in recommending a rate for
22 non-subscription services, you didn't consider

1 the number of channels or streams offered by
2 non-subscription services, compared to
3 subscription services, did you?
4 A That's true.
5 Q And you'd expect the number of
6 channels or streams to be important to
7 consumers when they value a service, wouldn't
8 you?
9 A Yes.
10 MR. JOSEPH: May I have a moment,
11 Your Honor?
12 Thank you, Dr. Pelcovits. Thank
13 you, your Honor, I have no further questions.
14 CHIEF JUDGE SLEDGE: Ms. Brown,
15 any cross-examination?
16 While we transition, why don't we
17 take a ten minute recess?
18 (Whereupon, the foregoing matter
19 went off the record at 3:18 p.m. and went back
20 on the record at 3:30 p.m.)
21 CHIEF JUDGE SLEDGE: Thank you.
22 We will come to order.

1 Ms. Brown?
2 BY MS. BROWN:
3 Q Good afternoon, Dr. Pelcovits,
4 Kris Brown on behalf of NPR.
5 A Good afternoon.
6 Q I'd like to draw your attention to
7 page 5 of your testimony, written testimony.
8 At the bottom of the page, in the last
9 paragraph, you state I also assume that both
10 the willing buyer and willing seller in this
11 hypothetical marketplace are commercial
12 entities fully motivated to maximize profits.
13 And then you go on, on page 6 to say thus,
14 I do not attempt to set separate rates for
15 noncommercial entities or hobbyists that are
16 not seeking to maximize profit or even those
17 small webcasters that may be unable to survive
18 without the benefit of a below market
19 statutory license.
20 A Yes, I see that.
21 Q Okay. So I just want to clarify,
22 you never made any attempt to derive a rate

1 for noncommercial entities, including National
2 Public Radio in your analysis. Is that
3 correct?
4 A I did not try to derive a separate
5 rate for those entities, no.
6 Q Okay. But you would agree,
7 wouldn't you, that the statutory standard does
8 not preclude setting a rate for public
9 broadcasting and non-commercial entities,
10 isn't that correct?
11 A To my best recollection, that's
12 correct.
13 Q Okay. And do -- you agree, don't
14 you, that the buyers, the willing buyers, as
15 you conceptualize them, are not comparable as
16 between public broadcasters and commercial
17 webcasters, isn't that correct?
18 A I'd agree with that.
19 Q And would you agree that it's
20 possible that a willing seller might have an
21 interest in setting more than one rate if
22 market segmentation of the consumers were

1 possible?

2 A If it would be a segmentation that

3 would segment consumers, yes, but not

4 necessarily of producers selling to the same

5 consumers.

6 MS. BROWN: Okay. No further

7 questions.

8 CHIEF JUDGE SLEDGE: Mr. Malone,

9 would you like to inquire?

10 BY MR. MALONE:

11 Q Good afternoon, Dr. Pelcovits.

12 This morning, Mr. Joseph was

13 asking you in the anti-trust context about

14 interactive licenses and, as I caught it, your

15 testimony was that interactive licenses were

16 "one of the many markets in which sound

17 recordings are provided" and then you went on

18 to say that record companies use multiple

19 channels to distribute these products. And

20 would you consider these to be examples of

21 market segmentation?

22 A Not in the sense of the question I

1 just answered from Ms. Brown. Market
2 segmentation can mean simply markets that are
3 different based on the characteristics of the
4 supply side and, namely, you can provide
5 something in one channel using a variety of
6 different techniques of delivering it, let's
7 say, how you get it to the car versus how you
8 get it to the home? It can also be, from a
9 demand side, you're going to try to segment
10 consumers in a way to maximize profits.
11 Q But -- let's see if I can build on
12 that. Consider the analogy to private
13 labeling in the grocery store and Dole
14 provides certain fruits under the Dole label
15 and they also provide certain fruits under the
16 Giant label and these sell to the consumer at
17 different prices. And Dole receives different
18 prices from the grocery store, does it not?
19 A I don't know that for a fact but -
20 -
21 Q Well --
22 A -- I'll carry that forward, carry

1 the assumption --

2 Q All right.

3 A -- forward is fine for me.

4 Q So, in this case, the hypothesis,

5 the pineapple, fruit, whatever it is, is the

6 same in both the cans and it's merely the

7 wrapping that is different?

8 A Sure.

9 Q And so, --

10 CHIEF JUDGE SLEDGE: Well, that's

11 another assumption you make.

12 MR. MALONE: Well, --

13 CHIEF JUDGE SLEDGE: That Dole

14 sells the same fruit under two different

15 labels.

16 MR. MALONE: Let's ask the witness

17 if he knows.

18 CHIEF JUDGE SLEDGE: Well, he's

19 already says he doesn't know.

20 MR. MALONE: I didn't understand

21 him to indicate that, Your Honor.

22 CHIEF JUDGE SLEDGE: Oh, I'm

1 sorry.
2 THE WITNESS: I was accepting that
3 as an assumption, --
4 MR. MALONE: I see.
5 THE WITNESS: -- quite frankly. I
6 was not testifying --
7 MR. MALONE: I see.
8 THE WITNESS: -- as a pineapple
9 expert.
10 (Laughter.)
11 BY MR. MALONE:
12 Q But from your experience in the
13 economics business, there are examples of
14 private labeling where the product is
15 precisely the same?
16 A I'd expect there are.
17 Q And, but again, the manufacturer
18 in that case is after profit maximization?
19 A Yes.
20 Q Looking to page 45 of your
21 testimony, about the middle of the page in the
22 paragraph that begins Live365 reports, you say

1 that you have assumed an average of 15.5 plays
2 per hour. I don't find any other discussion
3 of that numerical value elsewhere in your
4 testimony and I'm asking where it comes from?
5 A I believe I used the conversion
6 ratio that currently converts plays to the
7 hourly fees under the statutory license.
8 There but -- I would think it comes pretty
9 close to what the number of plays are in a
10 subscription service.
11 Q All right. Assuming for a moment
12 that's correct, did you do any analysis or
13 investigation as to whether the 15.5 is
14 applicable across the webcasting industry as
15 a whole? I mean, what's the range here that
16 we're really working with?
17 A I would suspect the range, if
18 we're including commercials networks as well
19 as noncommercial networks, that it would be
20 below 15.5 for the commercial networks and
21 15.5 might in fact be about where it is for
22 the subscription networks?

1 Q And then you mentioned
2 noncommercial and I didn't understand where
3 you put that.
4 A I didn't. I must have been
5 mistaken. What I meant the distinction
6 between subscription and non-subscription.
7 So, I expect that the non-subscription
8 commercial by their meaning it has
9 commercials, in non-subscription market, the
10 non-subscription webcasts supported by
11 commercials, that those would tend to have
12 fewer plays than the subscription market which
13 does not have commercials because of the time
14 and the hour that it's being used by the
15 commercials, leaving less time for music.
16 Q But you didn't make any actual
17 measurements as to noncommercial simulcasts,
18 that is, simulcast by noncommercial
19 broadcasters?
20 A I did not make an assessment of
21 that, correct.
22 Q And you have no data then on that

1 point at all?
2 A I have not looked at any data on
3 that.
4 Q And to what extent does this 15.5
5 plays per hour, what's the sensitivity
6 analysis on that figure?
7 A It's directly -- I mean, it's a
8 direct mathematical relationship if it's -- if
9 the number of plays were higher, and we were
10 to continue with the assumption of 45 hours
11 per month, then, for example, if there were 20
12 plays, you would get 900 plays per month and
13 you'd divide 900 into the monthly fee, the
14 $1.63 and get the resulting per play fee of
15 $1.63 divided by 900. So --
16 Q So the only place you use the 15.5
17 is in connection with attributing a per play
18 value based on a subscription service?
19 A Well, it's based on the
20 assumptions as stated here, which I did -- I
21 was not even trying to capture exactly what's
22 going on in the market because, as I said, the

1 Live365 claims 32 hours per month and I
2 grossed that up quite a bit. So, it's an
3 attempt to try to give what I believe is a
4 reasonable and conservative number. It's not
5 scientifically pegged to a specific type or
6 use of webcasting.
7 Q But in fact the 32 hours per month
8 may have no particular applicability to
9 certain types of simulcast?
10 A It might not.
11 MR. MALONE: I think I have no
12 further questions.
13 CHIEF JUDGE SLEDGE: Mr.
14 Freundlich, I believe, has left. He was here
15 earlier. Have everyone had their opportunity
16 to cross-examine?
17 (No response.)
18 CHIEF JUDGE SLEDGE: All right,
19 thank you. Any redirect Mr. Handzo?
20 MR. HANDZO: Yes, Your Honor, if I
21 might just have a minute to collect my notes,
22 --

1 CHIEF JUDGE SLEDGE: Certainly.
2 MR. HANDZO: -- I would appreciate
3 it.
4 MR. JOSEPH: Your Honor, while Mr.
5 Handzo is collecting, I do have a housekeeping
6 question, actually. Are we expecting Mr.
7 Simson to come over or are we -- I need to
8 make appropriate arrangements, if we are. I'm
9 just not sure.
10 MR. HANDZO: Well, we're actually
11 sort of in email contact as we speak. When we
12 had -- I guess my sense would be, between the
13 redirect and what I would expect to be
14 recross, I would expect that we would eat up
15 enough of the rest of our small remaining time
16 that it didn't make sense to bring him.
17 MR. JOSEPH: I don't object to
18 that, Your Honor, I just wanted to know
19 whether I needed to have people come over.
20 CHIEF JUDGE SLEDGE: That seems
21 very unlikely.
22 MR. JOSEPH: Okay.

1 CHIEF JUDGE SLEDGE: Why don't we
2 just go ahead and secure that possibility.
3 That doesn't make any sense for me to -- it
4 would take you that long to get through
5 security.
6 MR. JOSEPH: Thank you, Your
7 Honor.
8 (Laughter.)
9 REDIRECT EXAMINATION
10 BY MR. HANDZO:
11 Q Good afternoon, again, Dr.
12 Pelcovits.
13 A Good afternoon, Mr. Handzo.
14 Q Dr. Pelcovits, when you were
15 testifying yesterday, you were asked whether
16 you made an adjustment in your benchmark with
17 respect to tethered downloads. Do you recall
18 that?
19 A I do.
20 Q Okay. And would you remind us
21 what tethered downloads are?
22 A Sure. Tethered downloads that are

1 obtained from the subscription webcast service
2 by the subscribing customer. They are
3 downloaded to the computer and they are
4 essentially like a mission impossible kind of
5 tape. They will magically erase themselves if
6 you end your subscription to the service. And
7 there's also a mechanism for tracking how many
8 plays are made of the music on the person's
9 computer when they're offline as well as
10 online.
11 Q Now, as I understand it, under
12 certain circumstances, you know, some services
13 might allow you to transfer that tether
14 download to a portable device. Is that
15 correct?
16 A Yes, that's correct, usually at an
17 additional fee.
18 Q Okay. And so where there could be
19 a transfer to a portable device, am I right
20 that you didn't include those services when
21 you determined your benchmark?
22 A When I determined my benchmark and

1 developed this 0.55 adjustment factor, that's
2 correct.
3 Q Okay. So, what we're talking
4 about in terms of adjustment is tethered
5 downloads that cannot be put onto a portable
6 device?
7 A That's correct.
8 Q All right. Now, with respect to
9 those kinds of tethered downloads, do you
10 recall reading the testimony of Mr. Roback of
11 Yahoo with respect to services that Yahoo
12 offers that have both tethered capability and
13 non-tethered capability?
14 A I don't recall his testimony. I
15 do know that Yahoo provides, as part of its
16 Yahoo music service, tethered downloads as
17 part and parcel of the music service that it
18 offers on subscription basis.
19 Q All right. Let me see if I can
20 refresh your recollection here. I'm going to
21 mark this as SoundExchange Exhibit 276 DP,
22 just to continue with our number system.

1 (Whereupon, the document
2 referred to as
3 SoundExchange Exhibit No.
4 276 DP was marked
5 for identification.)
6 BY MR. HANDZO:
7 Q Have you had a chance to review
8 that?
9 A I have.
10 Q And do you see where Mr. Roback
11 says that MusicMatch on-demand has one version
12 where you can get conditional tethered
13 downloads?
14 A I see that.
15 Q Okay. And you see that Yahoo does
16 not charge any more for that capability?
17 A Yes.
18 Q Does that affect your opinion as
19 to whether you would need to adjust for
20 tethered downloads?
21 A I think I said earlier there is an
22 implicit adjustment, there's not an

1 adjustment, but this value to the -- the
2 potential value to the consumer of tethered
3 downloads is included in the overall
4 adjustment I make. And, specifically with
5 respect to MusicMatch and, I think, across the
6 market, these tethered downloads are becoming,
7 they're at a normal feature of the
8 subscription music services.
9 Q Okay. So, it's already been
10 adjusted for, in effect?
11 A It has already been adjusted for.
12 Q All right. Now, you also said
13 that you didn't make a separate adjustment for
14 bit rates or sound quality?
15 A That's correct.
16 Q Can you explain to us why you
17 didn't do that?
18 A I did not make a separate
19 adjustment for bit quality because there is
20 nothing under the statute that restricts the
21 bit rate for the statutory webcasts to be
22 anything different than what it is for the

1 interactive services. It's up to the
2 webcaster what bit rate to provide the service
3 at and, if that's up to the webcaster, then
4 the record labels would expect to charge a
5 single rate rather than make an adjustment
6 based on what webcasters might have done in
7 the past or whatever happens to be in the
8 market right now.
9 Q You also testified that you didn't
10 make a separate adjustment for the number of
11 channels offered by a given webcaster. Again,
12 why not?
13 A For the same reason that it's up
14 to the webcaster what type of service to try
15 to put together and sell in the market. And
16 under the statutory license, they can provide
17 whatever type of service in terms of number of
18 channels, how narrowly targeted the channels
19 are to consumers and sell that in the market.
20 And that, I believe, since it's up to the
21 webcaster how to use this music subject to the
22 restrictions in the statute, that it shouldn't

1 have a separate adjustment between the
2 interactive market and the non-interactive
3 market.
4 Q Now, you also have some questions
5 about the fact that you used as your benchmark
6 subscription services and whether that sort of
7 model is then applicable to ad supported
8 services.
9 The first question, I guess, is,
10 let's assume for the sake of argument that the
11 revenues for ad supported services were
12 different than the revenues for subscription
13 services. Would that have any impact on the
14 percentage of revenue component of your
15 proposed fee?
16 A Well that would, that would not --
17 that would actually lead to less being paid
18 where there is less revenue being collected.
19 Q So the percentage of revenue fee
20 is in effect, self-adjusting?
21 A It's self-adjusting where there is
22 no subscription fee or alternatively, where

1 the per play rate doesn't also come into the
2 market.
3 Q So, in terms of the application of
4 your model to an ad supported service, the per
5 subscriber rate is not relevant because there
6 are no subscribers. Correct?
7 A Right.
8 Q And the percentage of revenue is,
9 in effect, self-adjusting?
10 A Correct.
11 Q And so what we're really talking
12 about here is the per play rate?
13 A Yes.
14 Q Now, in your view, Dr. Pelcovits,
15 would record companies be able to
16 differentially price with respect to the per
17 play rate as between ad supported services and
18 subscription supported services?
19 A Under the statute -- I mean, it
20 depends on how the statutes is actually and
21 how the Court rules.
22 Q Well, let me put it this way. I

1 guess I'm not asking as a legal matter. Is a
2 willing seller going to want to price
3 differently between the two?
4 A Not necessarily. Not without a
5 very compelling evidence that that was going
6 to increase their revenues, rather than
7 decrease their revenues. So, so long as there
8 is a certain degree of consumer
9 substitutability between non-subscription and
10 subscription services, the record companies
11 would be putting their revenues at risk if
12 they tried to set a lower rate for the
13 subscription services, I'm sorry, for the non-
14 subscription services and the subscription
15 services.
16 Q And they would be putting their
17 revenues at risk, why?
18 A Because the lower, the lower
19 price, namely, if the lower prices for non-
20 subscription services would yield a
21 potentially better deal for consumers and
22 consumers would use those rather than

1 subscription services, so I mean, the term is
2 cannibalization but it's essentially
3 substitutability on the consumption side for
4 the two services and low prices drive out high
5 prices.
6 Q Now you were asked some questions
7 recently by Mr. Joseph about assuming that
8 there were certain prices in the market for a
9 subscription interactive service and a
10 subscription non-interactive service. I think
11 the numbers he used were $6 and $8 and then he
12 asked you what would happen if you changed the
13 fee. Do you recall that?
14 Now, in your view, if the fee
15 charged by the record companies in the non-
16 interactive market changed, would that change
17 the price to consumers?
18 A I expect it would, yes.
19 Q Okay. So, there would simply be a
20 new equilibrium reached there?
21 A There would be a new equilibrium
22 reached.

1 Q Let me ask you to look at page 51
2 of your testimony. And down towards the
3 bottom, you talked about your assumption of a
4 linear demand curve. Do you see that?
5 A I do.
6 Q And you characterized it as a
7 neutral assumption. Do you see that?
8 A Yes.
9 Q Can you tell us why?
10 A Yes. It's neutral because the
11 effect of a price change on the quantity
12 demanded can be more pronounced or less
13 pronounced than what is indicated by the
14 linear demand curve. So, that's why I called
15 it a neutral assumption. It's a very standard
16 in economics to give you a result where you
17 don't have the wealth of data you would need
18 to try to estimate a specific form of the
19 demand code.
20 Q In other words, a different
21 assumption might have favored the webcasters?
22 A It could go either way.

1 Q Okay. You were asked some
2 questions, I think this morning, by Mr.
3 Steinthal, who was positing that the prices
4 charged to consumers in the interactive market
5 might be set artificially low by the
6 webcasters because they wanted to build an
7 audience. Do you recall that?
8 A Yes.
9 Q Okay. Now, when you derived your
10 rate in this case, you were using a ratio
11 between the fee charged by the record
12 companies and the price charged to consumers.
13 Do you recall that?
14 A Yes.
15 Q And that ratio was based on the
16 ratio in the interactive benchmark market. Is
17 that correct?
18 A Correct.
19 Q Okay. Now, if the price to
20 consumers were to go up such that the
21 percentage of revenue component of the fee
22 became the operative fee, would the increase

1 in consumer price change the ratio?
2 A No, it wouldn't.
3 Q Why is that?
4 A The nature of percentages that if
5 you're charging, let's say, 40 percent of a
6 price, then the ratio's going to be 0.4. It
7 doesn't matter where the price is.
8 Q Okay. So, if Mr. Steinthal were
9 correct and the consumer price went up, that
10 wouldn't change the ratio on what which you
11 based your analysis?
12 A No. It would not change the ratio
13 based on a percentage of revenue portion of
14 the fee structure.
15 MR. STEINTHAL: Your Honor, I'm
16 not sure what ratio he's referring to. So, my
17 objection is to the question insofar as I'm
18 not sure what ratio, of all the ratios that
19 have been talked about, the witness is
20 referring to.
21 CHIEF JUDGE SLEDGE: Is that a
22 proper objection?

1 MR. STEINTHAL: Well, I hope so.
2 (Laughter.)
3 CHIEF JUDGE SLEDGE: I think
4 that's more a question for your next time to
5 examine.
6 MR. STEINTHAL: Okay.
7 MR. HANDZO: Let me -- I'm happy
8 to try and clarify it because --
9 CHIEF JUDGE SLEDGE: You may
10 oppose Mr. Handzo.
11 MR. HANDZO: At this point, I can
12 use all the help I can get.
13 BY MR. HANDZO:
14 Q The ratio that we were just
15 talking about, is that the ratio between the
16 fee charged by record companies in the
17 interactive market and the price charged to
18 consumers in the interactive market?
19 A Yes.
20 Q Okay.
21 MR. STEINTHAL: I'm glad he
22 clarified that.

1 BY MR. HANDZO:
2 Q Dr. Pelcovits, let me ask you to
3 take a look at The Services Exhibit 62, which
4 is the Arbitron study.
5 A I have that now.
6 Q Okay. And I believe Mr. Steinthal
7 directed your attention to paragraph 25 on
8 page 14?
9 A Yes, I believe.
10 Q And correct me if I'm wrong, but I
11 think what you indicated there was the fact
12 that there might be a correlation between
13 streaming and CD purchases did not mean that
14 there was a causal effect between the two?
15 A Yes.
16 Q Let me ask you to take a look at
17 the next paragraph, paragraph 26.
18 A I see that.
19 Q All right. And do you see that
20 that reports that people who stream see more
21 movies?
22 A Yes.

1 Q What does that -- does that affect
2 your opinion about whether there's a
3 correlation or causation here?
4 A I think it's a good example of a
5 correlation and --
6 Q Rather than causation?
7 A -- it's showing the danger of
8 drawing conclusions about causation from
9 correlations.
10 Q Dr. Pelcovits, do you have any
11 experience with consumer surveys that attempt
12 to get consumers to either predict or report
13 the level of their consumption of goods or
14 services?
15 A I do.
16 Q Tell us what that experience is?
17 MR. STEINTHAL: Your Honor, this
18 is -- I object. I believe this is beyond the
19 scope of our cross-examination. This witness
20 is experienced in surveys.
21 CHIEF JUDGE SLEDGE: On that
22 objection, with the examination involving such

1 a survey, the subject Exhibit 62 is overruled.
2 THE WITNESS: I do have experience
3 with quite a lot of surveying that was done in
4 the telecommunications industry. And I would
5 say that, as a general matter, surveys are not
6 very good at obtaining estimates from
7 consumers of sort of how many things they buy
8 and how much they spend. And that the
9 industry, the telecommunications industry,
10 certainly relied much more on data that was
11 obtained from customer bills rather than
12 anything from surveys.
13 BY MR. HANDZO:
14 Q Now, you mentioned in response to
15 one of --
16 MR. JOSEPH: Just a point of
17 clarification, whose surveys would you be
18 referring to there? Surveys done by the
19 industry or a wider group of surveys?
20 THE WITNESS: This would really be
21 both, that either conducted internally or
22 conducted by an outside party.

1 MR. JOSEPH: And including
2 government surveys?
3 THE WITNESS: I'm sorry, I didn't
4 --
5 MR. JOSEPH: Including government
6 surveys?
7 THE WITNESS: I don't have
8 knowledge of surveys by the government asking
9 people how much they spend in specific, very
10 specific, industries. So, I can't say.
11 MR. JOSEPH: Okay. I just wanted
12 to clarify which surveys we were talking
13 about.
14 BY MR. HANDZO:
15 Q You mentioned in response to one
16 of Mr. Steinthal's questions that you actually
17 looked at the overall shipments of CDs in the
18 U.S.?
19 A I did.
20 Q Can you tell us what you found
21 when you did that?
22 A I did. I found that the average

1 number of CDs purchased per person in the
2 United States is far lower than indicated from
3 the survey here. This indicates an average
4 American purchases 13 CDs in the past year and
5 I recall a later Arbitron study showing ten
6 CDs a year. If you take CD shipments which
7 are approximately 700,000,000, which is public
8 RIAA data and divide it by, if not the entire
9 population, the populations say of all of a
10 certain age, age ten or so, you're going to
11 get about three and a half CDs as the average
12 number of CDs purchased per person.
13 And that would indicate that
14 customers responding to the survey are
15 overestimating what they're spending or that
16 their survey is not very representative of the
17 population.
18 MR. HANDZO: May I just have a
19 moment, Your Honor?
20 CHIEF JUDGE SLEDGE: That's fine.
21 MR. HANDZO: I believe that's all
22 I have.

1 CHIEF JUDGE SLEDGE: Mr.
2 Steinthal, any recross?
3 MR. STEINTHAL: Just briefly, Your
4 Honor.
5 RECROSS-EXAMINATION
6 BY MR. STEINTHAL:
7 Q Dr. Pelcovits, first of all, on
8 this issues of subscription, non-subscription
9 and pricing at the higher value use versus not
10 pricing at the higher value use and avoiding
11 cannibalization, that general subject that's
12 come up, let me ask you this question.
13 Assume if you will,
14 hypothetically, that ten percent of the demand
15 in a market is willing to pay nine units per
16 good for a certain good. Okay?
17 A Okay.
18 Q And assume 90 percent of the
19 market demand is not willing to pay, directly
20 or indirectly, more than 1.1 units for the
21 same good. Wouldn't you agree with me that a
22 profit maximizing seller, if it had to choose

1 between selling to the highest value user at
2 nine units for ten percent of the demand and
3 the 90 percent of the market willing to pay
4 1.1 unit, they'd be better off selling to the
5 90 percent of the market?
6 A No, because that presumes. I can
7 do the math, too. Your math would show you'd
8 get 90 units of currency from the ten percent
9 versus 99 units of currency from the 90
10 percent of the demand and, therefore, it would
11 appear, based on your example, to suggest that
12 you're better off setting a price of 1.1. But
13 that assumes that what you observe in the
14 market by a 10 percent/90 percent breakdown is
15 itself going to stay the same. If you were to
16 only offer the $9 price.
17 Q Well, hypothetically, it is going
18 to stay the same. If that's the assumption
19 and you have no evidence upon which to assume
20 that the consumers are going to change their
21 behavior from that assumption, the profit
22 maximizing seller would sell to the 90 percent

1 of the market. Right?
2 A If you make all of those
3 assumptions, yes.
4 Q Okay. Now, the ratio question.
5 A Oh, no.
6 Q I need to put this back up, just
7 to clarify something because now I know why I
8 was confused. Because I was thinking about a
9 different ratio than the one that you were
10 testifying about. I just want to confirm
11 that.
12 Back to 6.2. Let's focus on line
13 3 of each of those entries on 6.2. That
14 refers to a ratio, does it not?
15 A It does.
16 Q And that's not the ratio you were
17 addressing in responding to Mr. Handzo.
18 Correct?
19 A That's correct.
20 Q And it's true, is it not, and I
21 think we went over this when I asked a
22 question, which is to clarify, if the monthly

1 price paid by the benchmark market interactive
2 services increased, the ratio would decrease.
3 So you'd go from a ratio of one to two,
4 perhaps to one to three, or one to four,
5 depending on just how high that price for the
6 benchmark market service went up. Correct?
7 A Yes.
8 Q And hypothetically, the lower
9 those ratios are, the lower the resulting
10 price, in your model. Correct? For the non-
11 interactive target market service?
12 A For the non-interactive target
13 services that I calculated to be $4.56, yes.
14 That would be a lower number.
15 Q Okay. Now the testimony you gave
16 about surveys?
17 A Yes.
18 Q First of all, in your experience
19 as an economist, I gather you have relied upon
20 some surveys in your experience?
21 A I have.
22 Q And without reviewing the

1 underlying specifics in terms of who has been
2 surveyed and what the parameters are, I gather
3 you would just be uncomfortable giving any
4 testimony about whether a given survey is a
5 good one or a bad one?
6 A Unless I knew the organization
7 that performed it.
8 Q And by the way, you gave some
9 testimony about the CD sales or shipments.
10 First of all, were you referring to sales or
11 were you referring to shipments?
12 A I don't recall how the RIAA
13 reports which of the two is reporting.
14 Q And it's fair to say that what you
15 were testifying to is that you had come across
16 certain data that you were recalling, but it's
17 true that you didn't do any analysis of the
18 sales and shipments data of the recording
19 industry as part of your engagement here?
20 A I reviewed a lot of statistics. I
21 did not compute them or examine the underlying
22 data. That is publicly reported by RIAA every

1 year and it's reported on their website and
2 downloaded and that's the number I was talking
3 about.
4 MR. STEINTHAL: One second, Your
5 Honor. I have no further questions, Your
6 Honor.
7 CHIEF JUDGE SLEDGE: Mr. Joseph,
8 any further questions?
9 MR. JOSEPH: No further questions,
10 Your Honor.
11 CHIEF JUDGE SLEDGE: Ms. Brown?
12 MS. BROWN: No further questions,
13 Your Honor.
14 CHIEF JUDGE SLEDGE: And Mr.
15 Malone?
16 MR. MALONE: Yes, please, Your
17 Honor.
18 CHIEF JUDGE SLEDGE: All right.
19 BY MR. MALONE:
20 Q Dr. Pelcovits, I was a little bit
21 confused by your arithmetic computations in
22 response to Mr. Steinthal's hypothesis

1 concerning ten percent of the market being
2 nine units and that 90 percent of the market
3 paying 1.1 unit. And I understood your answer
4 to be that if the seller priced the 90 percent
5 of the market, he would get 99 percent or 99
6 units.
7 Is it not true, however, that the
8 ten percent of the market would also purchase
9 at the lower price?
10 A It very well might.
11 Q So even that event would get 100
12 percent of the market?
13 A Well, you get 100 percent of the
14 market in either case, once you have a single
15 price. It's a question of in which price
16 times which quantity gives you more money.
17 Q All right. Let me ask the
18 question then a little more carefully.
19 MR. HANDZO: I'm sorry. I feel
20 some need to interpose an objection here. I'm
21 not sure it's appropriate to recross on
22 somebody else's recross. He can recross on my

1 redirect, but not Mr. Steinthal's recross.
2 CHIEF JUDGE SLEDGE: Well, we'll
3 give Mr. Malone a little leeway.
4 MR. MALONE: I think we're one
5 question away, Mr. Handzo.
6 MR. HANDZO: I'm sorry I held it
7 up then.
8 BY MR. MALONE:
9 Q So, in terms of units, what would
10 the seller in that case be bringing in the
11 door at the lower price?
12 A Well, can we use -- I'll call the
13 units dollars --
14 Q You may.
15 A -- United States dollars. So, in
16 which case, if you set a price at $1.10 and
17 you sold, previously you were selling ten
18 units in the high end, 90 units in the lower
19 end, you'd now be selling 100 units at $1.10,
20 so you'd get $110.
21 Q So, the incentive for the lower
22 price would be slightly greater than your

1 original answer?

2 A The -- yes, the money you would

3 get is greater than what I previously

4 indicated. You're right.

5 Q And the profit maximizing seller

6 would choose the larger number, I take it?

7 A Well, he'd hopefully do the math

8 right and he'd choose between $110 and $9

9 times however many units would have been sold

10 in the market, should the $9 commodity be the

11 only thing available.

12 CHIEF JUDGE SLEDGE: All right.

13 That seems to conclude the examination of Dr.

14 Pelcovits.

15 The parties present couldn't

16 appreciate the phenomena that as soon as we

17 determined, about 15 minutes ago, that we were

18 going to finish earlier than expected, there

19 were, the attitude of this room significantly

20 improved.

21 (Laughter.)

22 CHIEF JUDGE SLEDGE: That's the

1 first time I've seen smiles on people's faces
2 in a couple of days. It's been quite
3 refreshing.
4 That completing the evidence
5 today, anything to address before we adjourn?
6 MR. HANDZO: Only, Your Honor,
7 that I have just been handed SoundExchange's
8 response to RLI's motion requesting referral
9 of material questions of substantive law,
10 which I understand has been filed. So again,
11 if the Court would like courtesy copies, I can
12 distribute those.
13 CHIEF JUDGE SLEDGE: No, thank
14 you.
15 MR. HANDZO: Okay.
16 CHIEF JUDGE SLEDGE: All right. I
17 have omitted a critical part of our day. I
18 hope it doesn't affect the mood of the room.
19 Any question from the bench to Dr.
20 Pelcovits?
21 JUDGE ROBERTS: Mr. Pelcovits, if
22 I'm correct, you testified earlier that, in

1 your determination, the rate that the CARP set
2 in 2002 was a below market value rate. Is
3 that correct?
4 THE WITNESS: Yes. I said, as we
5 see right now. I didn't try to judge the
6 market of 2002, but I believe it's below what
7 the willing buyer and willing seller would pay
8 now.
9 JUDGE ROBERTS: In the current
10 market?
11 THE WITNESS: In the current
12 market.
13 JUDGE ROBERTS: And, therefore, I
14 take it that means you did not seek to apply
15 your model to any data from 2001 or 2002 as to
16 whether the CARP got it right at that point in
17 time?
18 THE WITNESS: That's correct.
19 JUDGE ROBERT: Do you have any
20 view as to whether the CARP got it right in
21 2002?
22 THE WITNESS: No, I don't. I have

1 not tried to look at it from that perspective.
2 JUDGE ROBERTS: Thank you. That's
3 all.
4 CHIEF JUDGE SLEDGE: Judge
5 Wisniewski?
6 JUDGE WISNIEWSKI: Just a couple
7 of questions.
8 Dr. Pelcovits, we've been talking
9 a lot about demand curves in this proceeding
10 so we haven't really said a whole lot about
11 the supply curves, the underlying supply
12 curves.
13 I wonder if you can tell me what
14 you think the shape of the supply curve is in
15 the ultimate output market here, the consumer
16 market that you talked about? And then, also,
17 the supply curve or the shape of the supply
18 curve in the input market that you talked
19 about?
20 THE WITNESS: I'll be happy to
21 address that. I think in the output market,
22 it is a very elastic supply. The factors of

1 production, other than the input we're talking
2 about, the music are readily available, easily
3 reproducible and can accommodate significant
4 increases in supply without an increase in
5 price.
6 I think with respect to the music,
7 they're really, with respect to the music that
8 is already created, there really is no change
9 in the traditional sense of more of that being
10 recreated. Essentially, it's a license and
11 actually, from the standpoint of supply of
12 more licenses, if there was no copyright
13 owner, it would be again, infinitely elastic
14 supply. So, we're really, -- what happens in
15 the market is --
16 JUDGE WISNIEWSKI: Wait, let me
17 catch up. What did you say?
18 THE WITNESS: Infinitely elastic
19 supply. JUDGE WISNIEWSKI: With
20 respect to?
21 THE WITNESS: With respect to
22 licenses. Licenses are, essentially, are just

1 a permission. So, if there was multiple
2 competing providers of a copyright license to
3 the same sound recording, I would say it would
4 command a zero price. And you could provide
5 infinite amounts of it at a zero price.
6 JUDGE WISNIEWSKI: So, you're
7 looking at it, the product being supplied, as
8 being a license that is somehow unlimited in
9 terms of what it can deliver. Is that what
10 you're saying?
11 THE WITNESS: That's how I'd look
12 at the issue of supply, in a traditional sense
13 of looking at supply. If what we're
14 considering is the copyrighted music, as the
15 law stands that only the copyright owner can
16 offer more of it, it's really not a
17 traditional supply curve. It's a profit
18 maximization calculation that the supplier
19 undertakes. So, it's not as if you can say
20 what the price will be at any particular level
21 of output, because that depends on -- it's not
22 an intersection, strictly speaking, of a

1 demand and supply curve, it's an intersection
2 of a demand curve and a profit maximization
3 calculation by the supplier. JUDGE WISNIEWSKI:
4 Well, if we have a blanket license, doesn't
5 that actually fix the supply over the term of
6 the contract?
7 THE WITNESS: I don't think I put
8 it that way. I think the supply might be,
9 the supply here, -- I sort of see the market
10 as, if we're thinking of sort of the quantity
11 as being the number of subscribers to these
12 different services, or the number of times the
13 music is listened to, or something of that
14 nature, there's really no cost associated from
15 the copyright owner's standpoint. No physical
16 costs. There are opportunity costs, but there
17 is no actual production costs of having that
18 music played again, again, and again by as
19 many subscribers as possible.
20 JUDGE WISNIEWSKI: So then, if I
21 could pursue this just a bit further. If I
22 can try and understand what you're saying

1 here.

2 The supply wouldn't be fixed

3 because even though the number of sound

4 recordings might be fixed, the number of times

5 that they could be played is infinitesimal or

6 infinite, I should say?

7 THE WITNESS: Yes. Yes. And also

8 with respect to the number of sound

9 recordings, there are new ones being produced

10 all the time, so there is some supply,

11 traditional sort of supply, curve in that

12 market.

13 JUDGE WISNIEWSKI: So, from an

14 endpoint of view, it's not actually the sound

15 recordings but the number of times that they

16 could be played?

17 THE WITNESS: That's the way that

18 I've tried to analyze it with respect to this

19 market for the blanket license, yes.

20 JUDGE WISNIEWSKI: Okay. I'm just

21 trying to get a handle on that, from your

22 perspective.

1 The -- I guess part of that, you
2 had, in your testimony, talked about a change
3 in the copyright fee being passed along to the
4 consumer dollar for dollar. Does that
5 actually result then in the typical fashion in
6 which you would apply, for example, a tax,
7 which would represent a shift in the supply
8 curve?
9 THE WITNESS: Yes.
10 JUDGE WISNIEWSKI: I guess the
11 last couple of questions that I have here
12 relate back to your regression in table 6.1.
13 Page 39 of your testimony.
14 THE WITNESS: Thank you, very
15 much. I've got it.
16 JUDGE WISNIEWSKI: I wonder if you
17 could, at the risk of altering the mood in the
18 room, I wonder if you could take us through
19 each of the arguments in your specification
20 here and tell us a couple of things about
21 them?
22 One, I'll give them to you all in

1 a lump so that you can -- one is, which of the
2 arguments ultimately proved significant and at
3 what level, at what confidence level?
4 Secondly, if you could tell me
5 what the source data was for each of the
6 variables?
7 And third, if you could tell me,
8 theoretically, as to how they fit together?
9 Why you chose the variables you chose in this
10 specification as opposed to some other group
11 of variables with respect to this quality
12 estimation?
13 THE WITNESS: By all means.
14 I think it's appropriate to start
15 with the dependent variable, which is
16 essentially for everyone else here, what we're
17 trying to explain through the regression. So,
18 at the risk of getting a lot of people in the
19 audience bored, essentially, we're taking the
20 monthly price and taking the logarithm of the
21 monthly subscription price and we have an
22 observation for every one of the 30 services.

1 Then, going down the list of variables -- let
2 me back up for a second.
3 The source data in all cases was
4 compiled by my staff, using the web pages of
5 the different music services. We started by
6 doing a very broad search to try to find all
7 the services that we could and these are the
8 ones that were the subscription services
9 available at the market, at that point in
10 time. We also attempted, from our own
11 efforts, to count the number of radio
12 stations, to essentially catalogue, we
13 essentially created a database and catalogued
14 the number of radio stations, whether or not
15 it was interactive, which here is meant to be
16 on-demand or not, and the same thing with
17 respect to download and sound quality. And I
18 apologize, I don't remember what the
19 breakpoints were in sound quality, at what bit
20 rate. And it was a little hard to determine
21 that, but to the extent the services reported
22 it, we tired to capture that. So, that's the

1 source data.

2 And then with respect to the

3 individual variables, there's first the

4 intercept. And the intercept simply sort of

5 roots the equation at some point, essentially

6 on the vertical axis. It's just simply a way

7 of fitting an equation. If you were to think

8 of this again for other members, other court

9 members, if you're thinking of trying to fit

10 a -- can I use a piece of paper here? Do you

11 mind?

12 JUDGE WISNIEWSKI: There's a

13 bulletin board --

14 THE WITNESS: Okay. That would be

15 fine.

16 If we were to imagine that we're

17 trying to explain something where we can

18 observe a spatter of data and the data tells

19 us something about the price and something

20 about, let's in this case, we're in two

21 dimensions, whether it's a number of radio

22 stations or whatever the explanatory variable

1 is, all the intercept does is say, let's draw
2 that line and have it hit this access there.
3 So, it's just simply telling you where to
4 start the line. And then all of these others
5 are telling you what the slope of the line is
6 with respect to that variable. So, that's the
7 intercept. It's highly significant and it's
8 just simply, that's just the nature of what
9 the data does.
10 The log of number of radio
11 stations and the square of the log of the
12 number of radio stations, we put in two
13 variables there. First we put it in logs,
14 because it would appear that this has a,
15 should have a percentage relationship between
16 number of radio stations and the price, rather
17 than that going from five to six was the same
18 as going from 200 to 201. That would -- if
19 you use a linear measure, you're going to make
20 the assumption that five to six is the same as
21 100 to 101, the logarithmic turns it into a
22 percentage relationship. So, that's the

1 reason for using a log.
2 The square of the log we tried out
3 just to see if there was some nonlinearity
4 even in the logarithmic form. We tried
5 various specifications here. None of them
6 proved to be very significant. And then, we
7 have interactivity which was a zero/one
8 variable. In other words, one if it is on-
9 demand, zero if it's not. And the coefficient
10 estimate is highly significant, T value of
11 4.5, which would give you a greater than 99
12 percent confidence interval.
13 The next variable, download to
14 portable device, is also a zero/one variable,
15 zero where it's not downloaded, one where it
16 is downloadable. Coefficient 0.48 and T value
17 2.57. I don't recall where that gives you as
18 far as confidence. My guess is that it would
19 be over 95 percent, but I'm not sure where
20 exactly it lies.
21 Sound quality was, from an
22 econometric standpoint, not very helpful. In

1 fact, it's the wrong sign because it indicates
2 that as sound quality goes up, people would
3 pay less. So, it's clearly not picking up the
4 true effect of sound quality. There's only a
5 very limited variation in the sound quality in
6 the sample we chose and I attach no
7 significance to it.
8 I also had, if you'll see in the
9 note, there were some dummy variables for
10 Digital Imported service and Bell South's
11 service. Those were outliers. The Digital
12 imported price and was way up there and wasn't
13 explainable by anything else. And, in fact,
14 I think as Mr. Steinthal pointed out to me,
15 they've dropped the price. So, we tried
16 various ways to deal with this. We excluded
17 them from the regression, we put in dummies.
18 In my opinion it was an aberration in the
19 market and that's how I treated it in the
20 regression. And I think that's how the market
21 seems to be treating it.
22 And the Bell South we, again, it

1 was an odd observation. And again, we tried
2 it with Bell South in and Bell South out. We
3 tried a lot of specifications and they
4 provided the same results or, as I said, some
5 of them such as sound quality, just didn't
6 give us anything satisfactory.
7 So, I hope that answers your
8 question, Your Honor.
9 JUDGE WISNIEWSKI: The values on
10 those two dummies were high. Right?
11 THE WITNESS: Yes, they were, I
12 believe. I can go back and check.
13 JUDGE WISNIEWSKI: While you're
14 doing that, one other question on the sound
15 quality variable. How did you quantify that?
16 I'm sorry, was it a --
17 THE WITNESS: I'm sorry. We set
18 up a tier. So, we said, when we originally
19 looked at these services, we said well, let's
20 try to do something about sound quality, and
21 we set up, or my research assistant set up
22 something where he set up, the right word

1 here is, sort of groupings. So, there was
2 from, lets say zero to 28 kilobits per second
3 was low quality, 28 to 56 was medium quality,
4 above 56 was high quality. And we actually,
5 I think one of the early observations we saw,
6 a little more variation in them when we looked
7 at the sample more carefully and looked at the
8 services more carefully, we found that there
9 was only one observation that turned out to
10 have medium quality. But all the others, it
11 seems pretty natural as part of being a
12 subscription service, were providing things
13 above a certain, I think it was 56 or 64 --
14 JUDGE WISNIEWSKI: I guess the
15 question I had was what numbers did you
16 actually use?
17 THE WITNESS: I don't recall. I'd
18 be happy to provide them.
19 JUDGE WISNIEWSKI: Okay. Thank
20 you.
21 And I take it that you did other
22 alternative specifications and tried them out,

1 is what I heard you say. Is that --
2 THE WITNESS: Yes, sir.
3 JUDGE WISNIEWSKI: Is that
4 correct?
5 Did you do an alternative
6 specification that had, that was limited to
7 the variables that you found to be significant
8 here?
9 THE WITNESS: The ones I have with
10 me here right now, I don't have a regression
11 like that. I don't know whether we tried it.
12 JUDGE WISNIEWSKI: Okay. I was
13 just curious as to whether you did or how that
14 might have come up.
15 I don't think I have any further
16 questions.
17 CHIEF JUDGE SLEDGE: Any further
18 questions generated by those posed from the
19 bench?
20 MR. STEINTHAL: I have one
21 question, Your Honor.
22 CHIEF JUDGE SLEDGE: All right.

1 RECROSS-EXAMINATION
2 BY MR. STEINTHAL:
3 Q Dr. Pelcovits, do I understand
4 from what you just said that the variable as
5 to the number of stations offered by the
6 service was such that you concluded that it,
7 the number of stations offered by the service
8 was not a significant or material aspect in
9 the value proposition?
10 A That's the regression results.
11 MR. STEINTHAL: Thank you.
12 CHIEF JUDGE SLEDGE: Judge
13 Wisniewski?
14 JUDGE WISNIEWSKI: Yes, I'm sorry,
15 I did have one further question. Just as a
16 matter of cleaning up an issue.
17 I believe that you had testified
18 with respect to demand elasticity for a number
19 of these markets. I was just wondering if you
20 had done any estimates of cross-price
21 elasticity of demand?
22 THE WITNESS: I did not.

1 JUDGE WISNIEWSKI: Thank you.
2 CHIEF JUDGE SLEDGE: Mr. Handzo?
3 MR. HANDZO: Nothing further.
4 CHIEF JUDGE SLEDGE: Okay. Well,
5 then that then completes our examination of
6 Dr. Pelcovits.
7 Any other matters to be addressed
8 before we recess for the day?
9 And our witness, again, in the
10 morning?
11 MR. HANDZO: I believe the
12 anticipated order is, I think, Brook Simson.
13 CHIEF JUDGE SLEDGE: Brook Vinson?
14 MR. HANDZO: Yes. I'm sorry, yes.
15 Fink. Fink Brook Vinson.
16 CHIEF JUDGE SLEDGE: Fink Brook?
17 MR. HANDZO: Yes.
18 CHIEF JUDGE SLEDGE: Thank you.
19 We'll recess until 9:30 in the morning.
20 (Whereupon, at 4:38 p.m., the
21 hearing was adjourned, to reconvene at 9:30
22 a.m., Wednesday, May 17, 2006.)

CERTIFICATE

This is to certify that the foregoing transcript in the matter of:

The Digital Performance Right in Sound Recording and Ephemeral Recordings (Webcasting Rate Adjustment Proceeding)

Before: Copyright Royalty Board

Date: Tuesday, May 16, 2006

Place: Washington, D.C.

represents the full and complete proceedings of the aforementioned matter, as reported and reduced to typewriting.

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