Before the
COPYRIGHT ROYALTY JUDGES
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

MICHAEL PELCOVITS

Principal, Microeconomic Consulting & Research Associates, Inc. (MiCRA)

October 2006

SX Trial Ex. 3

BEFORE THE
COPYRIGHT ROYALTY BOARD
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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**

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.

Since joining MiCRA in 2002, I have prepared reports and testimony on a wide range of applied microeconomic issues, including telecommunications and intellectual property. I testified on behalf of SoundExchange in Docket No. 2005-1 CRB DTRA. I have also 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, Cornell, Pelcovits & Brenner. From 1979 to 1981, I was Senior Staff Economist in the Office of Plans and Policy, Federal Communications Commission.

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 provide a recommended rate for the compulsory license fee to be set in this proceeding for the digital audio transmission of sound recordings set forth in 17 U.S.C. § 1114(d)(2). I understand that this rate will apply to the licensing of sound recordings by XM and Sirius for the services delivered to the two satellite television providers, Direct TV and DISH Network, and will also apply to similar non-interactive subscription music services of the same type (collectively "television-based digital music services" or "television-based services"). My goal has been to develop a rate that is fully compatible with the "willing buyer, willing seller" statutory standard set out in 17 U.S.C. § 114(f)(2)(B).

My proposal is to base the license fee for these subscription services on the methodology I used to develop a rate proposal for non-interactive webcasting, which I recommended to the Copyright Royalty Board in Docket No. 2005-1 CRB DTRA

("Webcasting Proceeding").[1] I believe this is a reasonable approach because the subscription webcasting services and these television-based digital music services are comparable in many respects. The underlying value to listeners of both services is, in many respects, similar. Each service provides generally commercial-free music that is, in most circumstances, available only over a television or computer (e.g., is not portable). This means that the buyers and sellers of the music used in these services would be likely to reach agreement on a fee that was comparable, absent a compulsory license. Furthermore, to the extent there is a difference in customer listening patterns on the two types of services, it is possible to make a relatively straightforward adjustment to address these differences. I propose such an adjustment in my testimony. Moreover, I understand that the same "willing buyer, willing seller" statutory standard applies both here and in the Webcasting Proceeding.

My testimony is organized as follows. In Section III, I discuss the nature of these particular subscription services and compare them to the statutory webcasting services, which I analyzed in the Webcasting Proceeding. In Section IV, I present a rate proposal for these subscription services based on an adjustment to the webcasting rate. Finally, in Section V, I discuss how this rate could be modified if the services were to provide better information on the listening behavior of the satellite TV customers.

III. COMPARABILITY OF TELEVISION-BASED DIGITAL MUSIC SERVICES AND WEBCASTING SERVICES

XM and Sirius provide very similar music services to Direct TV and DISH Network, respectively. XM provides 66 commercial-free music channels to Direct TV. Direct TV then provides 48 of the XM music channels for no additional charge to all of

[1] I understand my testimony in that proceeding will be incorporated by reference into this proceeding.

its subscribers, and an additional 18 XM music channels to its Total Choice Plus or Premier subscribers. Sirius provides 64 commercial-free music channels to DISH Network. DISH Network then provides all 64 Sirius music channels at no additional charge to the subscribers to its higher-end programming packages, e.g. America's Top 120.

The music service provided to satellite TV customers is similar to the services offered by many webcasters. Indeed, XM provides a webcasting service, XM Radio Online, which includes many of the same channels that are also available on Direct TV. XM Radio Online is provided at no extra charge to XM satellite radio subscribers and at a stand-alone price of $7.99 per month. Sirius also provides on-line radio at no extra charge to its satellite radio subscribers, but does not offer a stand-alone product. These on-line services, provided by XM and Sirius, license music under the statutory standard set forth in 17 U.S.C. § 114(f)(2)(B) and 17 U.S.C § 112(a)(1) for non-interactive webcasting services.

The similarity of the statutory subscription webcasting services and these television-based subscription services stems from the statutory requirements pertaining to listener interactivity and various limitations on the frequency of plays by a single artist or on a single album. From the listener's standpoint, the two services provide a similar experience, whose key features include: multi-channel, high quality, commercial-free music; inability to select individual songs, replay, or pause music. Also, both subscription webcasting and television-based subscription services are commonly provided on non-portable equipment, which is used primarily for other purposes than playing music, i.e. the home computer and the satellite receiver connected to a television

set.[2] And in both cases, consumers who want a higher-fidelity sound from these respective services can connect their computer, or their television set, to a home entertainment system and enjoy near CD-quality music over more sophisticated audio equipment.

In light of these similarities, I recommend adopting the same level of fees for both webcasting and television services. There are two reasons for this. First, some listeners are likely to view these services as close substitutes. Therefore, if the prices charged by the record companies to the suppliers of both services are different, this will lead to a distortion in the relative market prices to listeners and an artificial advantage being given to one delivery mechanism over the other. This would be economically wasteful and could disadvantage listeners, music service providers, and copyright holders. Second, even if the two markets are viewed in isolation, the customers' listening experience will be quite similar in both markets, and therefore their willingness to pay for the music content should be similar. A copyright holder is likely to set similar prices in two markets where the customers' willingness to pay is similar.

IV. RECOMMENDED RATE FOR TELEVISION-BASED DIGITAL MUSIC SERVICES

In the Webcasting Proceeding, I recommended a three-part rate structure, whereby non-interactive webcasting services would pay the greater of: (1) $1.37 per month per subscriber; (2) 30% of revenue derived from the music service; (3) 0.197¢ per play. I derived the level and structure of these rates from an analysis of the rates freely agreed to

[2] In proposing a separate rate for wireless webcasting, I noted the increased value of such services to consumers and the increased fee that would be required. I have assumed for purposes of this analysis that television-based services will remain tethered to non-portable devices for the period of this license. To the extent that ceases to be true, a different — and higher — rate would likely be required.

by the webcasters and the record companies in the market for interactive music services. I adjusted the rates in this benchmark market to account for the lower relative value to consumers of a non-interactive music service. In my opinion, this rate structure and rate levels reflect accurately the demand and supply considerations of a free market.

My recommendation in the Webcasting Proceeding was based fundamentally on my analysis of the per-subscriber rate in the interactive market. I used basic economic principles to demonstrate the relationship that would exist in a free market between copyright fees and retail prices, when both were stated on a per-subscriber basis. I then developed a recommended per-subscriber fee for non-interactive webcasting based on my estimate of the retail price that would be charged for a statutory webcasting service in a free market. I then derived the other two components of the rate structure (*i.e.*, the percentage of retail revenue and the per play fee) from data on fees, revenues, and number of plays in the non-interactive webcasting market.

In this case, however, it is more difficult to observe any of the three alternative measures of underlying consumer demand for the music provided by the television-based digital services. Unlike Internet-based services, here it is not possible to measure the number of times a copyrighted work is played, so a "per play" rate is impractical. In addition, consumers do not purchase the music service separately, so there is no published per-subscriber charge upon which to base the copyright fee.

Moreover, at least for the two services at issue here, it is difficult to determine a meaningful measure of revenue upon which to base a percentage-of-revenue fee. In their public version of the statements in the Webcasting Proceeding where these issues first were raised, XM and Sirius conceded that they provide these services primarily because

they provide a marketing opportunity for their subscription satellite radio services. They thus are certain to discount greatly their television-based music services. The revenue that XM and Sirius receive thus does not capture the benefit to them of providing the service. Moreover, even if XM and Sirius received payment for their music services, this would not reflect the actual value placed on the music in the marketplace, because the amount of the payment they demand would be based in part on the copyright fee that they must pay to the copyright holder. That fee, however, is set through regulation, and not in the marketplace, so that even if XM and Sirius demanded the full value for their services from satellite television providers in direct payments, that figure would not account for the true marketplace value of the copyright itself.

As I noted in my testimony in the Webcasting Proceeding, the marketplace evidence for a "greater of" rate structure for digital music services is overwhelming. In virtually every contract with interactive webcasters, record companies receive a royalty fee payment equal to the greater of a percentage of the digital music services' revenue or a per subscriber and/or per performance minimum fee. I see no reason not to adopt a similar approach here. The same principles that applied to webcasting apply here. Moreover, as noted above, the fact that XM and Sirius are not seeking to maximize their revenues for these services highlights the need for a "greater of" rate structure -- one that ensures fair compensation under a percentage of revenue (for services actually seeking to maximize revenues if and when such services enter the market) while at the same time using a per subscriber or other minimum that fairly captures the value of the use of the music by companies such as XM and Sirius.

For the percentage of revenue, I propose the percentage that I derived from the

webcasting proceeding: 30% of revenue. That seems especially appropriate here, given that the services are offering television-based and webcasting services side-by-side to the same consumers, and the threat of substitution between the services is very real.

As noted above, it is difficult, if not impossible, to calculate a per performance rate, but it is possible to derive a relevant per subscriber rate based on the fee I recommended in the webcasting case. Just as subscribers to webcasting services pay a certain amount for the music they listen to on webcasting services, so too subscribers to the television-based services effectively pay some portion of their subscription fees to listen to music through their satellite television. Given comparable services that may substitute for each other, copyright holders in sound recordings are likely to seek in the free market similar amounts for the same amount and type of music usage.

One possible proxy for this amount can be derived by comparing the listening patterns of listeners of television-based services to the listening patterns of subscribers to subscription webcasting services. The time spent listening to the services serves as a useful proxy for how much value customers attach to the services. By this method, one can calculate a rate that ensures that a copyright owner receives, as a minimum, the same amount for an hour of their music that is listened to on a webcast, as they do for an hour of music that it listened to on satellite television.

Accordingly, I propose in this case to compare the time spent listening to the XM and Sirius services by a Direct TV or DISH Network subscriber to the time spent listening to music over a webcasting service by a webcasting music subscriber. I then calculate a per-subscriber fee for the television-based services by multiplying the rate I recommended for statutory webcasting ($1.37/month) by this ratio of time spent

listening.[3] I believe the economic logic underlying my rate proposal in the webcasting proceeding supports this method for setting a copyright fee for the television-based services.

A recent survey conducted by Zoomerang on behalf of SoundExchange collected information on DirecTV and DISH subscribers' listening patterns. Zoomerang sent the survey to individuals whom it had identified as having previously purchased a DirecTV or DISH digital video recorders and, after asking whether those individuals currently subscribed to one of the services, asked the amount of time they spend listening to XM or Sirius music channels on their DirecTV or DISH systems. (Individuals who responded that they did not currently subscribe to either system were not asked the second question.) There were no other questions on the survey, and the responses to the relevant second question are reported in the table below.

[3] I am assuming that it will be possible to determine the number of subscribers to the satellite TV companies either from the television-based music service companies or from public reports of the satellite TV companies themselves.

Direct TV	
Weekly Hours Spent Listening	Number of responses
Service does not include XM	78
zero	149
0 to 2	136
2 to 4	83
4 to 6	47
6 to 10	35
10 to 20	29
>20	23
Total	580

Dish Network	
Weekly Hours Spent Listening	Number of responses
Service does not include Sirius	114
zero	152
0 to 2	132
2 to 4	63
4 to 6	51
6 to 10	24
10 to 20	16
>20	14
Total	566

In order to aggregate these responses it is necessary to make certain assumptions about: (1) how to treat respondents who indicate their service does not include XM, because XM is provided with every Direct TV package; (2) what point estimate to use for responses given within a range of listening time; (3) how to weight responses from Direct TV and DISH Network. I have estimated the average time spent listening using several different sets of assumption. The results are given in the table below.

Average Weekly Listening Time

	Dish	**Direct TV** (include)	**Direct TV** (exclude)
Low-end	2.0	2.3	2.6
Mid-point	3.0	3.3	3.8

The "low-end" results are obtained by using the low end in each range of hours (for example, zero, where the range is zero to two). The "mid-point" results are obtained by using the mid-point of each range of hours (for example, one, where the range is zero to two), and 25 hours for the above 20 hour range. The estimates for Direct TV differ depending on whether respondents indicating their Direct TV service does not include XM radio are treated as listening to zero hours or excluded from the sample altogether.

The results range from 2 to 3.8 hours of weekly listening per subscriber to one of

the satellite television networks. To err on the conservative side, I propose a rate for the television-based music services based on an assumed average listening per customer of two hours per week. I also assume four weeks per month (rather than an actual conversion of 4.33 weeks per month), which yields a conservative estimate of eight hours per month of listening per subscriber.

The next step is to calculate the ratio of time spent listening to television-based music service programming to the time spent listening to a subscription webcasting service. In my testimony in the Webcasting Proceeding, I based my recommended per-play rate on a measure of usage at 45 hours per month, based on public statements of webcasters and information about listening patterns. In order to maintain consistency between the rates in the two cases, I will use 45 hours per month as the basis for developing my recommendation in this proceeding. Therefore, the ratio of television-based music listening to webcasting music listening is 8-to-45, which is approximately 0.18.

The final step I take is to multiply my recommended rate in the webcasting case of $1.37 per subscriber month by the listening ratio of 0.18. This yields a rate for the television-based digital music services of 25¢ per subscriber per month. This rate would be applied on a monthly basis counting all subscribers of Direct TV or DISH Network.

Finally, I am aware that there are certain Direct TV or DISH Network subscribers who may receive two distinct sets of television-based digital music services. If each music service were charged the full rate I have proposed, there is a chance of double recovery by SoundExchange. To account for this possibility, I propose that in such a case the assessed fee be allocated among the two different services. A fair allocation

could be achieved through several different approaches. One straightforward approach would be to allocate the fee based on the number of different channels that each service provides, on the assumption that such an allocation reflects the way that music is used by the customer. Thus, if a service operating under a blanket license provided 10 channels of music and another service provided 90 channels, the license fee for that service would be 10/100, or 10% of the full fee. If the second service were also operating under the statutory license, it would pay 90% of the fee.

V. MODIFICATION OF RATE

I understand that through the discovery process SoundExchange may receive more detailed and more reliable information from the television-based services concerning the listening habits of satellite TV viewers. If that information becomes available, it would likely be a straightforward matter to update this report to reflect these better data. It is also possible that through discovery SoundExchange will obtain data that provide alternative ways to measure the value of the music provided to the television-based services. For this reason, I may supplement or amend this testimony upon receipt of additional information.

CONCLUSION

I calculate that SoundExchange's proposed rate of the greater of $0.25/subscriber/month or 30% of revenue is fully consistent with the "willing buyer, willing seller" statutory requirement.

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

Date: 10-30-06

Michael Pelcovits