

Before the
COPYRIGHT ROYALTY BOARD

In the Matter of)	
)	
ADJUSTMENT OF RATES AND TERMS FOR)	Docket No. 2006-1 CRB DSTR
PREEXISTING SUBSCRIPTION SERVICES,)	
AND)	
SATELLITE DIGITAL AUDIO RADIO SERVICES)	
)	
)	
)	

TESTIMONY OF GEORGE G. STRONG, JR.

I. INTRODUCTION

A. I have been asked to determine an appropriate royalty rate for Music Choice to pay for sound recording performance rights and rights to make ephemeral phonorecords of sound recordings used in Music Choice’s domestic residential services business pursuant to 17 U.S.C. 114(f) and (d)(2). Currently, Music Choice is paying Sound Exchange 7.25% of its monthly gross revenues from residential services in the United States for such rights and such rate is set to expire on December 31, 2007.¹

II. SUMMARY OF FINDINGS

A. Based on my analysis, as discussed below, I have concluded that a reasonable royalty rate would be 2.6% of domestic residential revenue for sound recording performance rights and 4% of such 2.6% performance rights rate for ephemeral recording rights, if any rate is to be considered at all, or a total of 2.7% of domestic residential revenues.

¹ Federal Register, vol. 68, no. 128.

III. QUALIFICATIONS

- A. I am a Managing Director and the General Counsel for Cornerstone Research in Los Angeles, California. I have been engaged as an expert witness on various types of litigations including, but not limited to, intellectual property, antitrust, breach of contract, class actions, malpractice, etc. and have testified numerous times in both state and federal courts. A current copy of my curriculum vitae with a detailed listing of the types of matters in which I have provided expert witness testimony is attached as Exhibit MC 31.
- B. I hold a Bachelor of Arts degree in Economics from Yale University and a Master of Business Administration degree from Harvard University. In addition, I have a Juris Doctorate degree from the University of San Diego School of Law and am a member of The State Bar of California and the American Bar Association.
- C. In addition to my education and experience, I am also a Certified Public Accountant, licensed by the states of California and Hawaii, with an Accreditation in Business Valuation from the AICPA and a Certified Management Consultant.
- D. With respect to this matter, my firm shall be paid \$590 an hour for my time spent in preparation and support of my opinion and shall be compensated at various rates of other colleagues also working on this matter.

IV. SCOPE AND CONTEXT OF WORK PERFORMED

- A. Cornerstone Research was retained by Thelen Reid & Priest LLP on behalf of its client, Music Choice, to quantify a reasonable royalty rate for Music Choice to pay SoundExchange² for the right to publicly perform sound recordings under 17 U.S.C. 114(d)(2) (“performance rights”) and make any number of ephemeral phonorecords under 17 U.S.C. 112(e) (“ephemeral rights”).
- B. In forming my opinions in this matter, various documents were considered. A list of those documents considered is attached as Exhibit MC 32.

² Per www.soundexchange.com, SoundExchange is a nonprofit performance rights organization designated by the U.S. Copyright Office to collect and distribute statutory royalties to sound recording copyright owners and featured and nonfeatured artists.

V. FACTUAL BACKGROUND

- A. Music Choice is a Pennsylvania general partnership whose partners include U.S. cable providers, record labels, and technology companies. Music Choice broadcasts digital audio music, with over 50 channels,³ primarily through cable operators. Music Choice is the successor company to Digital Cable Radio Associates (“DCR”) formed on March 1, 1991 for the purpose of “further developing and maintaining a programming service consisting of digitized music and audio programming.”⁴
- B. As noted in the Report of the Copyright Arbitration Royalty Panel (“CARP”) dated November 12, 1997, the Digital Performance Right in Sound Recordings Act of 1995 affords certain subscription digital audio services a compulsory license to perform sound recordings. Such compulsory license means that digital audio services have the option to perform sound recordings without obtaining the permission of recording companies and artists. According to the CARP, Congress realized that if the digital audio services were required to obtain such permissions, there would be substantial transaction costs. My understanding is that so long as a digital audio service meets certain criteria it is eligible for the compulsory license.⁵
- C. On September 9, 1996, DCR submitted its direct case to the Copyright Office of the Library of Congress in a proceeding to determine statutory license terms and rates for the digital performance rights. On November 12, 1997, the CARP released its report recommending a rate of 5% payable to the Recording Industry Association of America (“RIAA”)⁶ for digital performance rights.⁷ Thereafter, on April 30, 1998, the Librarian of Congress issued his final order setting the rate for the digital performance right in

³ www.musicchoice.com.

⁴ Digital Cable Radio and Subsidiary audited financial statements for the year ended December 31, 1996.

⁵ Report of the Copyright Arbitration Royal Panel dated November 12, 1997 pp. 1-3, ¶¶ 2-9.

⁶ Report of the Copyright Arbitration Royal Panel dated November 12, 1997, p. 63, ¶200.

⁷ There are essentially three rights at issue here: (1) “composition performance rights” of the author of the work which are administered by ASCAP, BMI, and SESAC; (2) “sound recording performance rights” of the performers of the music which are administered by RIAA; and (3) rights to make ephemeral phonorecords (digital copies) as part of the transmission process which are administered by RIAA.

sound recordings at 6.5%.⁸ A final decision was made by the United States Court of Appeals for the D.C. Circuit that a 6.5% royalty rate was reasonable on May 21, 1999 and was effective for the period ending December 31, 2001.⁹

- D. On July 3, 2003, the Copyright Office published its final rule adjusting the rates and terms for the statutory license for digital performance rights and making of ephemeral phonorecords¹⁰ by preexisting subscription services (“PES”),¹¹ like Music Choice, for the six-year period January 1, 2002 through December 31, 2007. Such rate was set as part of a private settlement agreement among the parties contesting rates and terms for PESs. The rate was set at 7.0% of each licensee’s monthly gross revenues from residential services in the United States for the 2-year period January 1, 2002 through December 31, 2003 and 7.25% of each licensee’s monthly gross revenues from residential services in the United States for the 4-year period January 1, 2004 through December 31, 2007.¹² In total, since the statutory license was enacted, Music Choice has paid ██████████ in royalties to the record labels.¹³
- E. The purpose of this report is to render an opinion on the appropriate rate for the period commencing January 1, 2008. Congress has stated that the determination of such a rate shall be guided by reference to four objectives, articulated in 17 U.S.C 801(b)(1) as follows:
1. To maximize the availability of creative works to the public;
 2. To afford the copyright owner a fair return for his creative work and the copyright user a fair income under existing economic conditions;

⁸ In re: Determination of Statutory License Terms and Rates for Certain Digital Subscription Transmissions of Sound Recordings dated April 17, 1998 (“Librarian Report”).

⁹ *Recording Industry Association of America v. Librarian of Congress*, 176 F.3d 528 (D.C. Cir 1999).

¹⁰ Ephemeral phonorecord refers to the making of digital copies of the music as part of the digital transmission process. This portion of the license was not included in the prior 6.5% rate.

¹¹ According to 17 U.S.C. 114(j), a “preexisting subscription service” is a service that performs sound recordings by means of noninteractive audio-only subscription digital audio transmissions, which was in existence and was making such transmissions to the public for a fee on or before July 31, 1998, and may include a limited number of sample channels representative of the subscription service that are made available on a nonsubscription basis in order to promote the subscription service.

¹² Federal Register, vol. 68, no. 128.

¹³ Testimony of David J. Del Beccaro, p. 3.

3. To reflect the relative roles of the copyright owner and the copyright user in the product made available to the public with respect to relative creative contribution, technological contribution, capital investment, cost, risk, and contribution to the opening of new markets for creative expression and media for their communication; and
4. To minimize any disruptive impact on the structure of the industries involved and on generally prevailing industry practices.

VI. BENCHMARK RATES

- A. To determine such a royalty rate, I begin by determining an appropriate benchmark rate that may later be further adjusted depending on the four objectives in 17 U.S.C. 801(b)(1). As Dr. Adam Jaffe (Professor of Economics and Dean of Arts and Sciences at Brandeis University) notes, “it is common – both in litigation and in voluntary commercial transactions – for royalties for the use of copyrights, patents, and other intellectual property to be established by reference to ‘comparables’ or ‘benchmarks’ rather than derived from explicit cost or value considerations.”¹⁴
- B. Prior Benchmark Rates for Preexisting Services: Composition Performance Rights Rate, Sound Recording Performance Rights Rate, and the Relationship between the Two:
 1. Composition Performance Rights Rates:
 - a. In the prior hearing, the Librarian determined an appropriate benchmark for a “ceiling” royalty rate for sound recording performance rights was the total fees for composition performance rights expressed as a percentage of underlying revenue paid to the organizations representing songwriters and composers.¹⁵ At the time, the total fees that were being paid for the composition performance rights to the

¹⁴ Testimony of Adam B. Jaffe in the hearing to determine Webcaster rates for the period January 1, 2006 to December 31, 2010, undated, p. 10.

¹⁵ “Using the license fees DMX and DCR pay for the right to perform musical composition in the BMI and SESAC repertoires and the anticipated payments that ASCAP will receive upon resolution of a rate dispute between itself and the Services, and not the interim rates that the Services currently pay ASCAP, which are usually lower than the final determination of the rate court, the Panel set an upper limit on the value of the performance right for the musical compositions.” Librarian Report, p. 39.

American Society of Composers, Authors and Publishers (“ASCAP), Broadcast Music, Inc. (“BMI”), and the Society of European Stage Authors and Composers (“SESAC”) (each a professional rights organization, or “PRO”) were estimated to be [REDACTED] of revenue because certain of the licenses were still being negotiated.¹⁶

b. Music Choice currently has agreements with ASCAP, BMI, and SESAC to pay royalties for composition performance rights as outlined below:

1.) Under the most recently executed license agreement between Music Choice and ASCAP, Music Choice paid a license fee of [REDACTED] of Music Choice’s Annual Gross Revenues.¹⁷ However, the license period of such agreement ended on [REDACTED]. My understanding is that a new license agreement between Music Choice and ASCAP has been signed for the period [REDACTED] and that the license fee will be [REDACTED] of Gross Revenues.¹⁸

2.) The current agreement with BMI notes that the license fee is [REDACTED] of Gross Revenues for the Programming Service, as defined.¹⁹

3.) With respect to SESAC, consideration for licenses going [REDACTED] [REDACTED]. However, it is noted that Music Choice paid SESAC [REDACTED].²⁰

According to internal financial statements provided by Music Choice, residential revenues for the period [REDACTED] were [REDACTED]

¹⁶ Testimony of David J. Del Beccaro, p. 5.

¹⁷ Music Choice Blanket License Agreement dated March 22, 2002, p. 5, section IV; such rate would be a constituent part of the total fees paid to all PROs.

¹⁸ Based on discussions with Music Choice personnel.

¹⁹ Music Choice Residential Music Service Blanket License Agreement dated January 6, 2006, p. 3.

²⁰ SESAC, Inc. Experimental Performance License for Music Choice dated July 1, 2005.

[REDACTED]

4.) Thus, the sum total of royalty rates paid to composers is [REDACTED]

[REDACTED]

c. In May 1995, Music Choice Europe conducted a study for the purposes of determining appropriate rates payable to professional rights organizations in Europe. Such study indicates that [REDACTED]

[REDACTED]

”22

2. Relationship Between the Composition Performance Rights Rate and the Sound Recording Performance Rights Rate:

- a. Dr. William Fisher (who provided rebuttal testimony in the Webcaster proceeding of 2001), in citing Paul William Kempton (who also testified as part of the Webcaster proceeding), notes that “in all four jurisdictions [France, Germany, the Netherlands, and Norway] the rates broadcasters pay to producers and performers either are approximately equal to or are less than (emphasis added) the rates they pay to the representatives of the owners of copyrights in musical works. From this combination of facts, one could reasonably infer, once again, that the former are deemed no more valuable than the latter.”²³
- b. In discussing the validity of the negotiated license fees with the three performance rights organizations (“PROs”), the Librarian noted the specificity of information

²¹SESAC, Inc. Experimental Performance License for Music Choice dated July 1, 2005.

²² Music Choice Europe Study, p. 5.

²³ Rebuttal testimony of William Fisher dated October 4, 2001, p. 34, ¶57 (footnotes omitted).

provided by actual license agreements²⁴ and Congress' intention that any fees paid under the new digital performance license should not diminish the importance of royalties payable to copyright owners of musical works.²⁵ This suggests that composition performance rights rates set an upper bound for sound recording performance rights rates and based on this evidence, I employ an assumption based on the Librarian's finding that the PRO royalty rates are an appropriate ceiling benchmark (hereinafter "ceiling assumption").

- c. As Karyn Ulman (VP of Licensing at Music Reports, Inc., an organization involved in music clearance licensing and royalty administration) testified in the Webcasting rate adjustment proceeding, "In my experience almost always the cost of the master recording and the cost of the underlying musical composition when licensing the same rights for the same project for the same use are almost always the same."²⁶ This suggests that there may be some equivalence in rates for the composition performance right and the sound recording performance right, but also supports the notion of an upper bound.
- d. As Dr. Adam Jaffe notes in his testimony in the recent Webcaster proceeding "The musical work and the sound recording are inextricably intertwined in producing the value of the public performance. In most cases, to make the performances, a user needs both rights....The available theoretical and empirical evidence suggests that the fee paid by users for the performance of a musical work provides an upper bound to the value of the performance of a sound recording."²⁷ This suggests that the rates for the sound recording performance right and the composition performance right should be similar.
- e. Based on a summary of an agreement with the British Performing Right Society and "Digital Radio," the royalty rate, where net broadcasting revenue is greater

²⁴ Librarian Report, p. 43.

²⁵ Librarian Report, p. 47.

²⁶ Testimony of Karyn Ulman, June 29, 2006, p. 25.

²⁷ Testimony of Adam Jaffe, undated, p. 19.

than approximately £1MM, is 5.25% of net broadcasting revenue for musical composition performance rights.²⁸ Such rate is the same for both commercial radio and satellite radio.²⁹ Based on a summary of license terms between the British entity Phonographic Performance Limited (“PPL,” which collects and distributes airplay and public performance royalties in the UK on behalf of 3,500 record companies and 40,000 performers) and radio stations qualifying for the traditional radio license the amount payable to PPL for composition performance rights is at a rate of 5% if net broadcasting revenue is greater than approximately £1MM.³⁰ Again, note the similarity between the sound recording and composition rates, thus suggesting the composition rate’s usefulness as a benchmark for the sound recording rate.

3. Using the same relationship establishing a ceiling on the benchmark rate as was used by the Librarian in the 1996 hearing - namely the “ceiling assumption” - would yield a benchmark rate in this case of [REDACTED]. Therefore, using the “ceiling assumption” and the current rate to PROs of [REDACTED] (2006) would challenge the appropriateness of the current rate of 7.25% that Music Choice pays for sound recording performance rights.
4. In sum, if we assume (1) performance rights are capped by composer’s rights and (2), composers rights have declined to [REDACTED], the new upper bound for performance rights is [REDACTED] of gross domestic residential revenues.

C. The 25 Per Cent Rule:

1. Another useful approach for corroborating a reasonable royalty is an analysis of sharing the profitability from use of intellectual property, in our case a copyright. To do so, we might draw on the “25 Per Cent Rule” used in patent cases to arrive at a baseline royalty rate.³¹ The 25% Rule posits that profits from exploiting patents

²⁸ Digital Radio (PRS Agreement) Summary.

²⁹ Commercial Radio (PRS Agreement) and Satellite Radio (PRS Agreement) Summaries.

³⁰ Licensing Terms for the PPL Traditional Radio License.

³¹ Goldscheider, Robert, et al, “Use Of The 25 Per Cent Rule In Valuing IP,” *les Nouvelles*, pp. 123 – 133 (December 2002).

might appropriately be and have frequently been shared between the patent owner and commercial exploiter or patentee in a 25% to 75% relationship. Such a one-quarter to three-quarter sharing takes into account the inherently greater business risks assumed by the exploiter while still giving the patent owner a reasonable return. By analogy, that rule would seem a useful corroborating methodology for our inquiry here.

- a. This rule states that generally, 25% of the profits generated through the use of the intellectual property at issue should be paid to the intellectual property owner, and 75% should be retained by the entity charged with exploiting the intellectual property in a commercial setting.
- b. In applying the 25% Rule to the instant case, one would look to the profits of Music Choice. Because Music Choice already incurs royalty expenses for composers and performance rights, its net profit should be analyzed before a charge for any royalty expense is made. One should therefore first add back all current royalty costs of the copyrighted material to net income to arrive at “pre-royalty” income. Thereafter, a pre-royalty profit margin can be calculated by dividing pre-royalty income by revenue. Finally, such pre-royalty profit margin is multiplied by 25% to calculate the “25% Rule Royalty Rate” for the copyright owner’s share. As shown on the attached Exhibit MC 33, conducting such analysis for the years 2001 through 2005 would result in royalty rates between [REDACTED] for both composers and sound recording rights.
- c. Such 25% Rule derived royalty rates conceptually include all royalties paid for the intellectual property driving the revenue, in this case, copyrighted material, and should be adjusted by first deducting [REDACTED] royalty paid to the PROs from each of them. This results in a range between [REDACTED] and the latter might be reduced to the [REDACTED] ceiling using the “ceiling assumption” of the rate paid to the PROs. Therefore, applying the 25% Rule to the years 2001 –

³² Since negative rates are not possible, I will assume a zero rate.

2005 suggests a range of rates payable by Music Choice for sound recording performance rights of between [REDACTED] of gross domestic residential revenues using the “ceiling assumption.”

- d. Two scenarios were forecasted for 2008 – 2010 for Music Choice:
 - 1.) Conducting a similar 25% Rule analysis to the future period 2008 – 2010 for the best-case projections results, as shown on Exhibit MC 34, in a range of royalty rates from [REDACTED]. Deducting the [REDACTED] due to the PROs results in a royalty rate range from [REDACTED] of gross domestic residential revenues for the sound recording performance right.
 - 2.) The same analysis performed for the “worst-case” scenario (assuming the loss of several accounts) results, as shown on Exhibit MC 35, in a range of royalty rates from [REDACTED]. Deducting the [REDACTED] due to the PROs results in a royalty rate range from [REDACTED] of gross domestic residential revenues for the sound recording performance right.
 - 3.) Therefore, applying the 25% Rule to the years 2008 – 2010 suggests a range of rates payable by Music Choice for sound recording performance rights of between [REDACTED] of gross domestic residential revenues.

D. Other Potential Benchmark Rates:

1. Webcaster Hearing:

- a. On February 6, 2004, the Library of Congress issued its final rule on the royalty rate applicable to “new subscription services”³⁴ including Webcasters. That royalty rate is 10.9% of gross revenues, [REDACTED] [REDACTED] which is the rate that Webcasters currently pay for digital performance rights and for associated ephemeral recordings.³⁵

³³ Since negative rates are not possible, I will assume a zero rate.

³⁴ According to 17 U.S.C. 114(j), a “new subscription service” is a service that performs sound recordings by means of noninteractive subscription digital audio transmissions and that is not a preexisting subscription service or a preexisting satellite digital audio radio service. New subscription services are commonly known as Webcasters.

³⁵ Webcasters have the option to also pay on a per-performance or aggregate tuning hour basis per Federal Register, vol. 69, no. 28. My understanding is that these are infeasible options for the purposes of determining Music Choice’s royalty because Music

b. There are, however, significant differences between Webcasting and preexisting subscription services:

1.) For Webcasters, customers pay a monthly subscription fee for the service and interact directly with that service. For PESs, customers receive the service primarily as part of a basic cable package. The PESs interaction is not with end customers but directly with the distributors.³⁶

2.) As discussed more fully below, while Music Choice's residential business has recently become profitable, it continues to have a cumulative net loss over its entire business existence, and its future prospects depend on a highly competitive and uncertain market, while there is significant potential for growth in Webcasting.³⁷

3.) [REDACTED]. Following is a summary of Music Choice's fees per customer per month:³⁸

Year	Revenue/Customer/Month
2001	[REDACTED]
2002	[REDACTED]
2003	[REDACTED]
2004	[REDACTED]
2005	[REDACTED]

[REDACTED]

Choice has no means of measuring the amount of performances or tuning hours heard by its customers as they transmit a constant stream of music.

³⁶ Testimony of David J. Del Beccaro, p. 14.

³⁷ Based on financial information provided by Music Choice and Testimony of David J. Del Beccaro, p. 14.

³⁸ Based on financial information provided by Music Choice and as shown in Exhibit MC 36.

- 4.) As noted in the testimony of David Del Beccaro, President and CEO of Music Choice, other significant differences between Webcasters and Music Choice include: (1) the Webcasters dependence on advertising revenues, (2) Music Choice's competition with other cable television offerings for listener attention, and (3) the mature, low growth market of Music Choice while Webcasting still has good growth prospects.³⁹
- c. Most importantly, as Exhibit MC 37 shows, were the Webcast rates applied to Music Choice residential revenues in the period 2001 through 2005, Music Choice would have experienced an average annual net loss of [REDACTED]. With such losses, no rational company would ever enter the residential digital audio services market and Music Choice would immediately have to exit. Even rudimentary financial analysis makes it abundantly clear that the economics underlying the Webcasting and PES industries are significantly different and [REDACTED].
- d. Based on [REDACTED] and the structural differences between the PES and Webcasting markets, it is my opinion that the current Webcaster rate is inappropriate for the purposes of developing a benchmark royalty for Music Choice.
2. In the December 2002 issue of the Licensing Economics Review - The Royalty Rate Journal of Intellectual Property, a summary of average royalty rates by industry is provided. The issue notes, at page 9, that "The music programming transactions added last year tended to be clustered around 3 to 5 percent royalty rates."⁴⁰

³⁹ Testimony of David J. Del Beccaro, pp. 13-14

⁴⁰ Licensing Economics Review - The Royalty Rate Journal of Intellectual Property, December 2002, p. 9.

- E. The current (2006) digital performance royalty rate of 7.25% is an inappropriate benchmark rate:
1. The current rate of 7.25% was set as part of a settlement agreement.⁴¹ Moreover, this rate was set under the shadow of litigation, a short time after the appeal over the prior rate establishment. My understanding from testimony provided by Music Choice CEO David Del Beccaro is that the parties wished to avoid further expensive legal proceedings that would have been more costly than the agreed-upon increase in rates.⁴² Because of this threat of litigation, and the associated costs, the determination of the current rate was not made in a free and open market-based transaction.
 2. Because the total license fees paid to PROs [REDACTED] is not the same as those benchmark estimates used in the first regulatory hearing which have been proven to be incorrect, a new analysis should be conducted considering the new economic environment (2007 et seq.).
- F. Therefore I have determined that an appropriate benchmark rate prior to any analysis of the four royalty factors as determined by 17 U.S.C. 801(b)(1) and using the “ceiling assumption” would be appropriately based on the following:
1. Using the total fees paid to PROs as a benchmark, as was done by the Librarian of Congress in the prior PES hearing suggests a “ceiling” rate of [REDACTED]
 2. The commonly used 25 Per Cent Rule for determining patent royalty rates suggests a rate of between [REDACTED]
 3. Using the rate selected for Webcasters of 10.9% [REDACTED] is unreasonable for a variety of reasons.
 4. A recent issue of Licensing Economics Review - The Royalty Rate Journal of Intellectual Property states that royalty rates for music performance rights are generally in the range of 3% to 5%,⁴³ far below the Webcaster rates and even the current 7.25% rate Music Choice is paying.

⁴¹ Federal Register vol. 68, no. 128.

⁴² Testimony of David J. Del Beccaro, p. 12.

⁴³ Licensing Economics Review - The Royalty Rate Journal of Intellectual Property, December 2002, p. 9

5. The current rate of 7.25% was set under the threat of expensive and time-consuming litigation and should not be considered a benchmark royalty rate for these proceedings.
- G. In my opinion, a reasonable benchmark royalty rate would be between 0% and [REDACTED] of Music Choice's gross domestic residential revenues. Such rates are a starting point only, and they will then be analyzed giving proper consideration to the four statutory royalty factors or objectives to be achieved under 17 U.S.C. 801(b)(1).

VII. EFFECTS OF POLICY OBJECTIVES TO BE CONSIDERED UNDER 17 U.S.C. 801(b)(1)

- A. My understanding is that the final determination of a royalty rate that Music Choice should pay for digital performance and ephemeral recording rights depends on how such a putative rate achieves or satisfies the four objectives or factors set forth in 17 U.S.C. 801(b)(1).
1. Factor 1: To maximize the availability of creative works to the public;
 2. Factor 2: To afford the copyright owner a fair return for his creative work and the copyright user a fair income under existing economic conditions;
 3. Factor 3: To reflect the relative roles of the copyright owner and the copyright user in the product made available to the public with respect to relative creative contribution, technological contribution, capital investment, cost, risk, and contribution to the opening of new markets for creative expression and media for their communication; and
 4. Factor 4: To minimize any disruptive impact on the structure of the industries involved and on generally prevailing industry practices.
- B. I explain below how the evidence I have considered would affect the appropriately selected benchmark rate of between 0% and [REDACTED]. This type of analysis is similar to "Georgia-Pacific" analysis typically used in patent cases whereby a benchmark rate is set and then various factors influence the ultimate rate that is set.

C. Detailed Analysis of the 801(b)(1) Royalty Factors:

Factor 1. Maximization of the Availability of Creative Works

- a. The Librarian noted in the prior hearing that the Copyright Panel’s “key” finding with respect to the objective to recognize each party’s relative contributions had to do with “expos[ing] the public to a broader range of music than does traditional over-the-air radio.”⁴⁴ In addition, the Librarian noted that “The promotional value [of having music played on Music Choice] comes from the constant airplay of new types of music not readily accessible in the marketplace, which in turn **stimulates record sales.**”⁴⁵ A portion of such sales is transferred to the singers in the form of royalties. Thus, because the presence of a service such as Music Choice provides an outlet for music that might otherwise not get air-time, and exposure on Music Choice stimulates sales (a portion of which goes to artists), it is reasonable to conclude that Music Choice stimulates creative works.
- b. In addition, since the prior hearing, Music Choice’s end-of-year residential customer base has grown significantly⁴⁶ (more than ten times) reflecting the more widespread availability of creative works since the last hearing as can be seen in Figure 1:

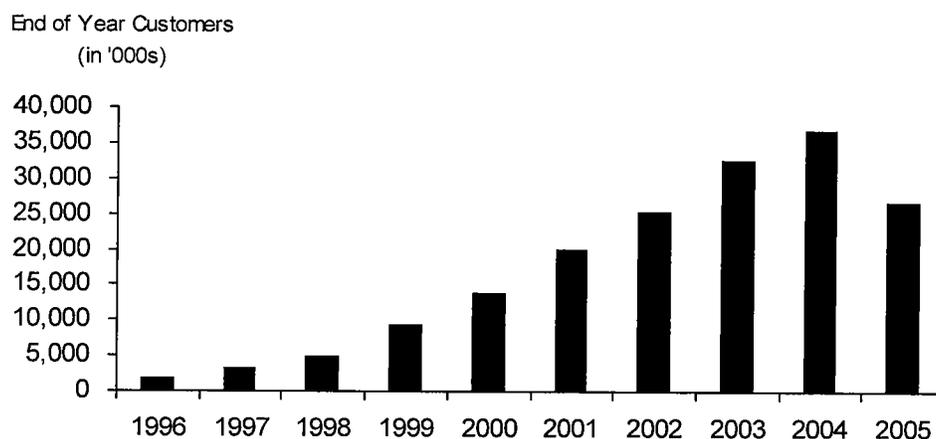


Figure 1

⁴⁴ Librarian Report, p. 55.

⁴⁵ Librarian Report, p. 57 (emphasis added).

⁴⁶ Based on financial information provided by Music Choice.

- c. Music Choice is an outlet for the types of music that are becoming rarer on traditional radio due to the consolidation of ownership of radio stations and lack of DJs with programming authority.⁴⁷
 - 1.) In 2005, Music Choice offered exclusive programming related to the “Sounds of the Underground” tour, providing an outlet for artists and encouraging creativity.⁴⁸ In 2004, Music Choice featured *Shadows Fall* on its show *Declassified*. The show is typically used as a way for artists to inform the public about their activities such as tour and album release dates and promotions.⁴⁹ My understanding is that it is relatively difficult for artists in the “metal” category to find exposure. By providing an outlet for such music, Music Choice is maximizing the availability of music to consumers.
- d. There is abundant evidence that Music Choice makes a significant contribution to maximizing the availability of creative works to the public, having increased customers substantially since the prior hearing and narrowed the gap between the maximizing efforts, though the record companies do also contribute to maximizing availability of creative works. As a result, there is a slightly upward influence within the range in which the benchmark should be set. Although it should be noted that any upward adjustment could never cause the rate to exceed the ceiling rate mentioned above.⁵⁰

Factor 2. Afford the Copyright Owner a Fair Return and the Copyright User a Fair Income

- a. In its 1998 Report, the Librarian noted that the process of determining the statutory rate by analyzing the other 801(b) factors ensures that the two requirements of this objective are satisfied.⁵¹

⁴⁷ Testimony of David J. Del Beccaro, p. 17.

⁴⁸ Press Release regarding “Sounds of the Underground” tour dated May 12, 2005.

⁴⁹ Case Study on Shadows Fall.

⁵⁰ *Recording Industry Association of America v. Librarian of Congress*, 176 F.3d 528 (D.C. Cir 1999).

⁵¹ Librarian Report, p. 63.

b. In addition to the above, however, additional analysis comparing industry costs of capital is instructive. Costs of capital provide us with information as to investor-demanded rates of return on their investments. We look at Return on Equity (“ROE”)⁵² as a measure of return.

1.) Returns at a 7.25% royalty rate (current rate paid by Music Choice):

a.) Based on Music Choice’s best-case projections for its residential business under a 7.25% royalty rate scenario for the three-year future period (January 1, 2008 through December 31, 2010), Music Choice experiences a return on equity (ROE) for the years 2008 through 2010 (based on the Music Choice best-case scenario) as follows:

Year	Return on Equity (ROE) at 7.25% Royalty rate (best-case projections)
2008	
2009	
2010	

Based on Music Choice’s worst-case projections for its residential business under a 7.25% royalty rate scenario for the three-year future period (January 1, 2008 through December 31, 2010), Music Choice experiences a return on equity (ROE) for the years 2008 through 2010 (based on the Music Choice worst-case scenario) as follows:

⁵² See Exhibit MC 38 for calculation.

Year	Return on Equity (ROE) at 7.25% Royalty rate (worst-case projections)
2008	[REDACTED]
2009	[REDACTED]
2010	[REDACTED]

These results compare unfavorably to a cost of equity capital (small composite CAPM + Size Premium) in SIC code 483 (Radio and Television Broadcasting Stations) of 16.94%, 4841 (Cable and Other Pay Television Services) of 19.51%, 4899 (Communications Services Not Elsewhere Classified) of 19.36% per year, and 7389 (Business Services Not Elsewhere Classified) of 21.02% as provided by Ibbotson Associates.⁵³ Clearly, at a royalty rate of 7.25%, Music Choice is not providing the rates of return demanded by investors in this industry.

2.) Returns at a 3% Royalty Rate:

- a.) Based on Music Choice’s best-case projections for its residential business under a 3% royalty rate scenario for the three-year future period (January 1, 2008 through December 31, 2010), Music Choice experiences a return on equity (ROE) for the years 2008 through 2010 (based on the Music Choice best-case scenario) as follows:

⁵³ Ibbotson Associates 2005 Cost of Capital Yearbook, pp. 4-19, 4-23, 4-25, and 7-22.

Year	Return on Equity (ROE) at 3% Royalty Rate (best-case projections)
2008	
2009	
2010	

Based on Music Choice’s worst-case projections for its residential business under a 3% royalty rate scenario for the three-year future period (January 1, 2008 through December 31, 2010), Music Choice experiences a return on equity (ROE) for the years 2008 through 2010 (based on the Music Choice worst-case scenario) as follows:

Year	Return on Equity (ROE) at 3% Royalty Rate (worst-case projections)
2008	
2009	
2010	

These results compare unfavorably to a cost of equity capital (small composite CAPM + Size Premium) in SIC code 483 (Radio and Television Broadcasting Stations) of 16.94%, 4841 (Cable and Other Pay Television Services) of 19.51%, 4899 (Communications Services Not Elsewhere Classified) of 19.36% per year, and 7389 (Business Services Not Elsewhere Classified) of 21.02% as provided by Ibbotson

Associates.⁵⁴ Clearly, at a royalty rate of 3%, Music Choice is closer (than at the 7.25% rate) to providing the rates of return demanded by investors in this industry, but still falls short of that demanded return.

- 3.) In summary at a rate of 3%, Music Choice is providing higher returns closer to, but still short of, those demanded by investors in its industry. Should the royalty rate be set at the current rate of 7.25%, investors' demanded return rate would be significantly unsatisfied and they should rationally shift their capital elsewhere, withdrawing capital from the digital audio services industry.
- c. The Goldscheider 25% Rule, which was used above to generate a benchmark rate, can also be used to analyze the appropriateness of royalty rates, including our putative 3% and 10.9%.
- 1.) As described above, the Goldscheider Rule generally states that 25% of the profits being generated by the use of intellectual property should go to the owner of the intellectual property while 75% should go to the user of the intellectual property, as a first approximation subject to particularized forces.
 - 2.) In using the Goldscheider Rule to analyze the returns to Music Choice and SoundExchange, we first consider fully loaded profits from Music Choice's residential business for the years 2008 through 2010, adding back any royalties paid, as shown on Exhibit MC 34, to arrive at a Pre-Royalty Income value. Dividing such Pre-Royalty Income by Revenues gives us a Pre-Royalty Profit Margin. On average, over the years 2008 through 2010, Music Choice will have a Pre Royalty Profit Margin of [REDACTED] per year.
 - 3.) The Goldscheider Rule tells us that 25% of the profits generated from the use of intellectual property should go to the owners of such intellectual property. Therefore, of the [REDACTED] Pre Royalty Profit Margin, [REDACTED] should go to the intellectual property owners as their fair share.

⁵⁴ Ibbotson Associates 2005 Cost of Capital Yearbook, pp. 4-19, 4-23, 4-25, and 7-22.

4.) But Music Choice currently has agreements with ASCAP, BMI, and SESAC for royalties of [REDACTED] of sales, one part of the intellectual property owners' component. [REDACTED]

- d. Analysis of profit sharing using the Goldscheider Rule commonly used in intellectual property matters suggests that, at a 7.25% royalty rate, and after considering the [REDACTED]
[REDACTED] This rate would certainly prove burdensome to Music Choice and does not suggest a fair return to Music Choice in exchange for the substantial risk it is taking.
- e. Even at a 3% royalty rate, the record companies would earn more than suggested by the 25% Rule.
- f. Therefore, it is reasonable to conclude that a 7.25% royalty rate is unreasonable for Music Choice, and even a rate of 3% would not satisfy investors nor comply with the 25% Rule. Therefore, analysis of the objective to provide fair returns to the copyright owners and a fair income to the copyright user suggests a strong downward adjustment in the benchmark rate.

Factor 3. Relative Roles of the Copyright Owners and Users in Making the Product Available to the Public

- a. The five sub-factors to be considered in assessing the relative roles of the copyright owner and user in making the product available are as follows:⁵⁵

⁵⁵ 17 U.S.C. 801(b)(1).

- 1.) Creative contribution;
- 2.) Technological contribution;
- 3.) Capital investment;
- 4.) Cost and risks to the industries involved; and
- 5.) Contribution to the opening of new markets.

b. *Creative contributions*

- 1.) Although in its 1998 report the Librarian concluded that the record companies were found to have made a greater impact than the Services (PESs) in creative contribution, it is important to note that Music Choice provides an outlet for music that might not otherwise receive airtime. Because such airtime does have significant promotional value that leads to increased sales and generates income for artists, which provides artists incentive to create new music, Music Choice is clearly contributing to creativity.
- 2.) Music Choice has spent over [REDACTED] to develop an On Screen system that provides, through enhanced television screen graphics, information regarding the artists and other relevant topics to viewers of its channels. Such information includes artist facts and images and album art, as Damon Williams has testified in the current matter.⁵⁶
- 3.) Record label representatives and artists often visit Music Choice offices to speak with programmers about new music⁵⁷ in Music Choice's New York production studio which was built at Music Choice's expense for purposes of generating exposure.
- 4.) Music Choice spent approximately [REDACTED] on a playback facility in its Manhattan office that combines programming, playback, and its music library in order to improve music programming.

⁵⁶ Based on financial information provided by Music Choice and Testimony of Damon Williams, p. 7.

⁵⁷ Music Choice Show Tape Log.

- 5) As David Del Beccaro notes in his testimony in this proceeding, Music Choice creates programming which constitutes “creative works.”⁵⁸
- 6.) Record companies also make a significant impact with regards to creative contribution as they are responsible for producing the music that ultimately gets distributed through Music Choice.
- 7.) Although record companies do make a substantial creative contribution, Music Choice has made significant investments, especially since the last regulatory hearing, that suggest the gap between the record companies’ creative contributions and those of Music Choice has narrowed. In my opinion, a balancing of the record companies’ and performers’ contributions and Music Choice’s contributions to creativity has a slightly upward influence within the range in which the benchmark rate should be set. Although it should be noted that any upward adjustment could never cause the rate to exceed the ceiling rate mentioned above.⁵⁹

c. *Technological contributions*

- 1.) The Librarian noted in the Librarian Report that “the [Copyright] Panel focused on the technological developments...the creation of technology to uplink the signals to satellites and transmit them via cable; technology to identify the name of the sound recording and the artist during the performance; and technology for programming, encryption, and transmission of the sound recording.”⁶⁰
- 2.) Such investments continue, a sample of which follows:⁶¹
 - a.) From 1999 – 2003, MC spent [REDACTED] to develop the On Screen element of its service.

⁵⁸ Testimony of David J. Del Beccaro, p. 16.

⁵⁹ *Recording Industry Association of America v. Librarian of Congress*, 176 F.3d 528 (D.C. Cir 1999).

⁶⁰ Librarian Report, p. 54.

⁶¹ Based on financial information provided by Music Choice.

- b.) From 2002 – 2003, MC spent [REDACTED] to build a more flexible digital playback system that allows for more diverse playlists.
- c.) From 1999 – 2006, MC spent [REDACTED] to build a website to allow the purchasing of music and dissemination of artist information.
- d.) From 2005 – 2006, MC spent [REDACTED] on building a playback facility to improve music programming.

3.) Music Choice continues to make significant investments in technology for this incremental marketing channel that ultimately benefit both the viewer and the record companies with increased exposure of music and justify a downward adjustment to the benchmark rate.

d. *Capital investment*

- 1.) The Librarian noted in the Librarian Report that “The Panel determined that the Services made a substantial showing of their [REDACTED] investment in equipment and technology.”⁶² As noted above, Music Choice continues to make significant capital investments with regards to technology.
- 2.) Between 1996 and 2005, Music Choice made capital investments of over [REDACTED],⁶³ standing in contrast to the record companies as the Librarian noted that the “RIAA did not suggest that any capital investment was required on its part.”⁶⁴ Clearly Music Choice’s aggregate capital investments have increased (more than tripled) since the time of the prior hearing.
- 3.) Music Choice continues to make a significant capital investment in all areas of its business that benefit record companies and viewers of the Music Choice service and, in my opinion, such capital investments merit a downward adjustment to the benchmark rate.

⁶² Librarian Report, p. 54.

⁶³ Capital investment spreadsheet provided by Music Choice.

⁶⁴ Librarian Report, p. 54.

proceeding suggests that revenues from its residential business are negligible.⁷¹ Effectively, Music Choice is the primary PES still serving the residential market. Despite its position, however, Music Choice faces an intensely competitive market that includes satellite companies such as XM Satellite Radio Inc. (“XM”), Sirius Satellite Radio Inc. (“Sirius”), MTV, traditional radio, and, to some extent, Webcasters.⁷²

4.) While Music Choice’s residential business has recently become profitable, it is important to note that their survival is questionable. The royalty fees that Music Choice pays to SoundExchange represent funds that could otherwise be put into marketing, sales, or technology efforts that would allow it to more effectively compete. According to the testimony of David J. Del Beccaro,

[REDACTED]

74

It is important to note that given Music Choice’s current penetration within the residential market and the aforementioned ability of other companies, Music Choice cannot rely on customer growth to generate future residential revenues and profits.⁷⁵ It may be difficult for Music Choice to generate new customers but easy to lose them. Finally, as discussed more fully elsewhere, the investors in Music Choice have contributed

[REDACTED]

)⁷⁶ to date and there remains a

⁷¹ Testimony of David J. Del Beccaro, p. 7.

⁷² Testimony of David J. Del Beccaro, p. 30.

⁷³ Testimony of David J. Del Beccaro, p. 25.

⁷⁴ Based on financial projections provided by Music Choice.

⁷⁵ Testimony of David J. Del Beccaro, pp. 6-7, 29.

⁷⁶ Testimony of David J. Del Beccaro, p. 24.

significant risk that such investors will not see a reasonable return on their investment.

- 5.) Conversely, there appears to be very little, if any, risk to the recording artists and labels. Other than providing CDs to Music Choice, there are no distribution or other costs, and as has been noted, very little risk of lost music sales due to Music Choice's digital transmissions. Any capital investment made by the labels in creating the music or developing its artists would have to be incurred whether or not Music Choice's service existed. As such, it is a sunk cost and should not be considered here.⁷⁷
- 6.) Over the past fifteen years, Music Choice has invested approximately [REDACTED] to develop, operate, program, and market its service⁷⁸ whereas I have not seen any evidence that suggests the record labels incur any significant expenses related to the PESs.
- 7.) There is substantial evidence from multiple constituents within the music industry that Music Choice provides significant promotional benefits. Such promotional benefits lead to increased sales which benefit record companies and artists.
 - a.) Music Choice has internally tracked the feedback it has received from record company executives that suggests Music Choice is decreasing the record company risk of lost sales and are actually stimulating sales. Such feedback includes record company executives acknowledging the exposure their artists receive through Music Choice's promotions, Music Choice's assistance in albums debuting high on the Billboard charts, and

⁷⁷ As Adam Jaffe notes in the Webcaster hearing "the costs of producing the underlying intellectual property are 'sunk'... In the case of sound recording rightsholders, the costs are covered by CD sales, and, increasingly, other digital media...The digital performance royalty is incremental to this substantial revenue." (pp. 22-23) and "the licensors of both the sound recording and the musical work rights face zero incremental cost in conveying the rights in question."(p. 27).

⁷⁸ Testimony of David J. Del Beccaro, p. 27.

Music Choice's assistance with exposing new or lesser known artists to Music Choice's customer base.⁷⁹

b.) Prior reports and current survey data indicate that Music Choice is improving the recording industry's returns by decreasing record company risks of lost sales and actually stimulating incremental sales:

i.) As the prior Librarian Report noted "Because subscribers frequently purchase new music heard for the first time on the service, the Panel found that record companies arguably benefit directly from the expanded musical formats offered by the Services."⁸⁰

ii.) According to a 2005 study conducted by Arbitron (an international media and marketing research firm), 38.2% of respondents say they have purchased a single or album because they heard it on Music Choice.⁸¹

iii.) The Copyright Panel previously noted the effect that exposure through digital audio services can have as the Panel "believed that the Services decreased the risk to the recording companies because the digital audio services have substantial promotional value. The promotional value comes from the constant airplay of new types of music not readily available in the marketplace, which in turn stimulates record sales."⁸² With the increase in Music Choice's customers, Music Choice's additional investments in On Screen technology, a production studio, and Music Choice's focused efforts on promotional activities, this value has grown substantially since the last hearing.

iv.) In fact, when the RIAA previously tried to argue that digital audio services do not contribute to sales, the Librarian remarked "RIAA's

⁷⁹ Testimony of Damon Williams, pp. 7-9.

⁸⁰ Librarian Report, pp. 55-56.

⁸¹ 2005 Arbitron Study Raw Data, Question 32a.

⁸² Librarian report p. 57.

...proposition that the Services do not promote sound recording sales is untenable where the record clearly shows that the record companies provide promotional copies to the Services."⁸³ According to the testimony of Damon Williams, such practice has increased to the point where Music Choice receives a promotional copy of all new releases.⁸⁴

v.) Dr. Jaffe correctly notes the promotional effect of airplay when he writes "a broadcast/webcast public performance also provides benefit to the owner of the underlying musical work or sound recording by stimulating sales of albums and other fixed media containing the work being performed."⁸⁵

c.) The most significant driver of record sales is airplay and Music Choice serves an important role in light of recent consolidation in the terrestrial radio market. Over the past several years, corporate ownership of radio stations has led to fewer and fewer radio formats being economically viable. Music Choice fulfills an important role in such an environment because it supports multiple formats and generates the promotional effects that are no longer to be had through terrestrial radio.⁸⁶

d.) Many recording artists believe that Music Choice offers a valuable promotional service and has beneficially impacted sales. This is evidenced by personal appearances artists have made on the channels.⁸⁷ In addition, according to testimony of Damon Williams, artists frequently thank Music Choice for its impact and cite beneficial impacts of their Music Choice exposure on record sales.⁸⁸

⁸³ Librarian Report, p. 57.

⁸⁴ Testimony of Damon Williams, p. 6.

⁸⁵ Testimony of Adam B. Jaffe, undated, p. 39.

⁸⁶ Testimony of Damon Williams, pp. 12-14.

⁸⁷ Testimony of Damon Williams, p. 2.

⁸⁸ Testimony of Damon Williams, p. 4.

requirements in the digital audio industry, further increasing the risks borne by Music Choice.⁹⁴

- 9.) Therefore, as a result of the factors discussed above, Music Choice clearly bears more costs and risks than do the recording artists and labels in relation to the digital audio transmission services. As such, a substantial downward adjustment to the benchmark royalty would be warranted.

f. *Opening of new markets*

- 1.) The Librarian Report noted that “the Panel’s key finding...was that the Services contribute more to the opening of new markets for creative expression through the development of the digital audio services.”⁹⁵ This was due to Music Choice’s exposing the public to types of music that cannot typically be found on over-the-air radio. A list of stations that Music Choice broadcasts lists over 50 stations with all of the same genres as were listed in the Librarian Report (“classical, jazz, alternative, and ethnic formats.”)⁹⁶ In addition there are categories such as reggae, opera, show tunes, big band, and swing and, as Damon Williams notes, heavy metal, jazz, and certain kinds of hip-hop⁹⁷ that are less likely to be heard on traditional radio.
- 2.) Mr. Del Beccaro notes the effects that consolidation has had on the music industry and how, for economic reasons, terrestrial radio does not provide the promotional impact it once did.⁹⁸ Consolidation has led to programming decisions being removed from individual stations to corporate managers. While such an action generates cost savings for the station owners, it limits the number of formats that can be supported in a given area. It also reduces the number of artists that record labels can introduce on terrestrial radio.⁹⁹

⁹⁴ Testimony of David J. Del Beccaro, p. 31.

⁹⁵ Librarian Report, p. 55.

⁹⁶ www.musicchoice.com.

⁹⁷ Testimony of Damon Williams, p. 13.

⁹⁸ Testimony of David J. Del Beccaro, p. 17.

⁹⁹ Testimony of Damon Williams, p. 13.

Against this backdrop, it is important to remember that Music Choice's channel lineup encourages listeners to hear music that is not otherwise available.¹⁰⁰

- 3.) As noted in the extensive discussion of the positive promotional benefit that exposure through Music Choice generates, Music Choice provides an outlet for artists that might not otherwise get exposure. This provides a significant benefit to both the artists and the record companies. Therefore, Music Choice is clearly contributing to the opening of new markets.
- 4.) Because of the wide variety of music that Music Choice makes available, much of which is not otherwise available, a downward adjustment of the benchmark rate is justified.
- g. In its 1998 report, the Librarian noted the Panel's conclusion that "the record companies contributed more [than the PES] in only one of the five areas under consideration in evaluating this statutory objective, and consequently, the rate should be set at a minimum level in favor of the Services."¹⁰¹
- h. Overall, given Music Choice's contributions in each of the five sub-factors to reflect the relative roles of the parties, a downward adjustment of the royalty rate would be warranted.

Factor 4. Minimization of any Disruptive Impact

- a. As noted above, one of Music Choice's former competitors (DMX) at the time of the prior hearing declared bankruptcy in 2005, suggesting that the prior rate may have been set too high. As noted above, although Music Choice's residential business is generating profits, it remains in a precarious financial position, and its future is far from certain. Any increase in the royalty rate, or even its continuance at current levels, could threaten Music Choice's ongoing profitability and even

¹⁰⁰ 1995 Music Choice Tracking Study, question A-57 in which almost 60% of respondents say that they receive a channel on Music Choice which is otherwise not received on radio in their area.

¹⁰¹ Librarian Report, p. 59.

- existence. To remain in business and be able to deal with the threat of competition, Music Choice would need as low of a rate as possible.
- b. Despite its residential music business having turned profitable in [REDACTED], Music Choice continues to exist in a competitive market that threatens its viability. Despite DMX's bankruptcy, Music Choice must contend with XM, Sirius, and MTV as potential rivals in the residential market and, to some extent, new subscription service providers, such as Webcasters.
- c. Between 1991 and 2000, the partners in Music Choice invested approximately [REDACTED]. Music Choice is forecast, for the period 1991 to 2010 to have cumulative residential pre-tax loss of [REDACTED].¹⁰² Therefore, over an approximately 20-year period, the investors in Music Choice will not enjoy a positive return on their investment, in fact no return at all. A higher royalty rate will simply prolong the time required to generate a return adequate to justify any rational investor's investment in Music Choice.
- d. Because of the size of the U.S. recording industry, income generated from a higher royalty rate would have an inconsequential effect on the RIAA while being disastrous for Music Choice. According to the RIAA, in 2005, the U.S. sound recording industry was over \$12B based on manufacturer shipments at suggested list prices.¹⁰³ In 2005, Music Choice's total revenues were less than [REDACTED] which represents approximately [REDACTED] of the entire record industry.
- e. As David Del Beccaro's testimony notes, it is clear that reducing the royalty rate will minimize the disruptive impact on the industries involved because of the various market pressures on (and relatively small size of) Music Choice.¹⁰⁴
- f. In my opinion, given the continuing uncertainty regarding, and increasing competition within, the future of the digital audio industry, a lowering of the benchmark rate is justified.

¹⁰² Based on financial information provided by Music Choice.

¹⁰³ RIAA 2005 Consumer Profile.

¹⁰⁴ Testimony of David J. Del Beccaro, p. 7.

D. Results of the 801(b) Factor (Four Objectives) Analysis:

1. As a result of all the evidence I have reviewed and the analysis I have performed, it is my opinion that a significant downward adjustment to the benchmark royalty rate would be warranted as shown in the following table:

Factor (Objective)	Impact on Benchmark Rate
1. Availability of Creative Works	Small Upward Adjustment within the Range
2. Fair Returns	Significant Downward Adjustment
3. Relative Roles	
a. Creative Contribution	Small Upward Adjustment within the Range
b. Technological Contribution	Downward Adjustment
c. Capital Investment	Downward Adjustment
d. Costs and Risks	Strong Downward Adjustment
e. Opening of New Markets	Downward Adjustment
Overall	Downward Adjustment
4. Disruption to the Industry	Downward Adjustment
Overall Conclusion of 801(b) Factor Analysis	Significant Downward Adjustment

2. In my opinion, a significant downward adjustment to the benchmark royalty could be reasonably quantified by a [REDACTED] reduction to the ceiling benchmark rate of [REDACTED], or 2.6% of gross domestic residential revenue.

VIII. EPHEMERAL RIGHT ANALYSIS

1. With regards to any royalty paid on ephemeral recordings, it is important to note that there is no independent value to such recording as the only use is to exercise the digital performance right.

- a. In citing Dr. Zittrain as part of the first Webcaster hearing, Dr. Jaffe notes that “these [ephemeral] copies do not achieve any purpose or create any economic value other than facilitating and effectuating the public...performances...there cannot be any economic value with the right to make these copies that is separate or distinct from the value of the performances they effectuate...It is the performances that generate the economic value.”¹⁰⁵
 - b. If one adds the 2.6% royalty rate for sound recording performance rights to the [REDACTED] rate paid for composition performance rights, one sees that there would be no margin left under a Goldscheider analysis (see above, p. 22, ¶c(4)).
2. Of the 10.9% royalty paid on revenues by Webcasters, 8.8% of that 10.9% was for the purposes of ephemeral recordings. If we take this relationship, we can find that:
- a. $2.6\% * 1 / (1 - 8.8\%) = 2.85\%$ (combined rate for sound recording performance and ephemeral recording rights)
 - b. Thus, the implied rate for the ephemeral recording rights in the present matter is $2.85\% - 2.6\% = 0.25\%$. However, we have already established that Webcaster rates are inappropriately high for our purposes.
3. My understanding is that Music Choice makes fewer ephemeral recordings for the purpose of exercising its digital performance rights than do Webcasters. In addition, at the time of the first hearing, Music Choice did make copies of recordings but the record labels never asked for a fee for such copies,¹⁰⁶ again suggesting negligible value.
4. As noted above, the initial regulatory proceeding for PESs resulted in a royalty rate for digital transmissions of 6.5% that did not include or mention ephemeral rights. Thereafter, the various interested parties reached a settlement agreement that stipulated a royalty rate of 7.0% between January 1, 2002 and December 31, 2003 and a rate of 7.25% between January 1, 2004 and December 31, 2007 that did include

¹⁰⁵ Testimony of Adam Jaffe dated April 6, 2001, p. 52.

¹⁰⁶ Testimony of David J. Del Beccaro, pp. 35-36.

ephemeral rights. Notably, when the royalty rate was previously increased to 7.0% from 6.5%, there was no indication that the reason was the ephemeral right, suggesting that the ephemeral right had negligible value.

- a. If we were to assume that the 0.5% increase from the prior rate of 6.5% to 7.0% was entirely due to an ephemeral recording rate, although there is no evidence it was, that increase would amount to 7.7% of the prior rate or slightly less than the 8.8% relationship of ephemeral rights to associated sound recording performance rights in the Webcasters agreement.
 - b. If we take such 7.7% rate and multiply it by the 2.6% rate recommended in this report, we would get an ephemeral recording rate of approximately 0.2% of revenues.
7. Therefore, a reasonable royalty rate for the ephemeral recording right would be between 0% and 7.7% of the royalty rate for sound performance recording rights (0% and 0.20%, respectively, of gross revenues). The midpoint of that range is 0.1% of revenues or 4% of the sound recording performance rate (which is approximately 2.6%).
 8. In my opinion, a reasonable rate for ephemeral recordings would be at most 0.1% of gross residential domestic revenues.

IX. CONCLUSION

1. In my opinion, a reasonable range for benchmark royalty rates is between 0% and [REDACTED] of Music Choice's gross domestic residential revenues.
2. An analysis of the objectives to be achieved under 17 U.S.C. 801(b)(1) justifies **substantially lowering** the royalty rate below the benchmark rate.
3. In my opinion, a reasonable royalty rate for the performance rights would be [REDACTED] of the "ceiling" benchmark rate of [REDACTED] or roughly 2.6% of Music Choice's gross domestic residential revenues.

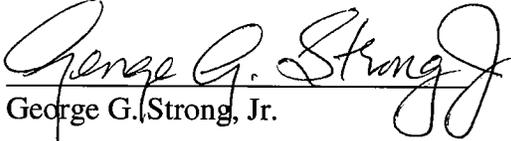
4. In my opinion a reasonable royalty rate for the ephemeral recording right is 4% of the sound performance rights rate which translates to 0.1% of gross domestic residential revenues, if any royalty rate is warranted given the nature of these rights.
3. Therefore, a combined reasonable royalty rate for the digital performance and making of ephemeral phonorecords is 2.7% of gross domestic residential revenues.

X. ADDITIONAL INFORMATION

1. Additional information may become available that may affect my calculations and resultant opinions. In such an event, I reserve the right to update my calculations and/or supplement my conclusions expressed in this report.

Pursuant to 28 U.S.C. § 1746, I declare under penalty of perjury that the foregoing is true and correct.

Executed in Los Angeles, California on the 26th of October, 2006.


George G. Strong, Jr.