Before the
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Washington, D.C.

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

TESTIMONY OF

EDGAR BRONFMAN, JR.

Chairman and Chief Executive Officer
Warner Music Group Corp.

October 2006

DIRECT TESTIMONY OF EDGAR BRONFMAN, JR

INTRODUCTION

Since 2004, I have been the Chairman and Chief Executive Officer of Warner Music Group Corp. ("WMG"), one of the world's largest music companies.[1] WMG, the only publicly traded stand-alone music company in the United States, is composed of many of the best-known labels in the music industry, including Atlantic, Bad Boy, Elektra, Lava, Maverick, Nonesuch, Reprise, Rhino, Sire, Warner Bros. and Word. WMG's Warner Music International, a leading company in national and international repertoire, operates through numerous international affiliates and licensees in more than 50 countries. WMG also includes Warner/Chappell Music, one of the world's leading music publishers, with a catalog of more than one million copyrights.

I am providing this testimony to emphasize the critical nature of this proceeding for WMG and the recording industry generally. I hope that the Board will consider the following points that are essential for setting a rate for the satellite services in this proceeding:

- It is a matter of fundamental importance that the royalty rates this tribunal establishes for satellite services reflect the fair value of copyrighted sound recordings.
- WMG and other record companies should not be forced to subsidize the satellite services through royalty rates discounted below the fair value of our music, especially given the satellite services' payment of fair value in the marketplace for other non-music content.

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1 Prior my role at WMG, I served as the Executive Vice Chairman of Vivendi Universal, which owns many entertainment companies, including Universal Music Group. From 1994 to 2000, I served as President and CEO of The Seagram Company Ltd.

- The royalty rates set in this proceeding should not be discounted to reflect any alleged similarity to terrestrial radio or any supposed "promotional" effect; satellite services are most certainly not "radio" and nothing in WMG's experience suggests that they "promote" sales of sound recordings in any meaningful way.

- The outcome of this proceeding will have a significant impact on record companies and their demonstrated ability to obtain fair value for their copyrighted works, both by directly determining revenue streams from satellite services and by setting a benchmark that could affect other transactions.

I elaborate on these points below.

TESTIMONY

In this testimony, I will first provide some background to explain the dramatic changes in the recording industry over the past decade as a result of the digital revolution, and WMG's role in that transition. I will then focus on the realities that should inform the setting of an appropriate royalty rate for the use by satellite services of copyrighted sound recordings.

I. Background

A. *The Transition to Digital*

Twenty years ago, there were really only two ways the public experienced recorded music: by listening to the radio for free or by purchasing a physical sound carrier – whether a vinyl LP, a cassette tape or a CD. Today, the public can experience music in a variety of ways. Consumers sitting at home can listen to music over their satellite receiving devices, choose from thousands of webcasting stations streamed from hundreds of websites, listen to a digital download on an mp3 player, listen to almost any sound recording they want streamed from a subscription music service, listen to music (including XM and Sirius) over their television set, or of course still listen to a CD they either purchased or burned themselves from their iTunes (or other) music library. Consumers in their cars or on the street can now do many of these same things — listen to music over their satellite receiving devices (installed in their cars or on portable devices), listen to a digital track wirelessly downloaded to their cell phones, and listen to almost any sound recording that has been conditionally downloaded from a portable subscription music service.

The benefits to consumers of this array of choices are obvious, but they also underscore the importance of record companies receiving fair value from all types of new distribution platforms as they emerge. To be sure, CD sales still generate most of the recorded music revenue for companies such as WMG, but that revenue stream is decreasing rapidly as consumers spread their disposable income over a wider variety of music offerings. That trend is certain to continue. As a record company, WMG embraces *all* viable, legitimate business models and believes that a myriad of distribution channels brings significant value to consumers by allowing consumers to listen to music in new and different ways. But it is critical in this world of diversified distribution outlets and platforms that record companies receive fair value for all of the uses of their sound recordings because our business model now depends upon multiple revenue streams from multiple formats.

B. *The Warner Music Group*

In 2003, a group of investors and I entered into an agreement to purchase WMG from Time Warner Inc. for $2.6 billion. It was an especially difficult period for the recording industry. The traditional CD-based business model was eroding rapidly, although there was not yet any significant revenue from new digital sources and, indeed, the rapid transition of consumers to music in digital form was seen by many as the bane of the industry as most of it was in the form of online piracy.

My investor partners and I believed in the promise of the digital revolution for the music industry. We foresaw that the transformation to digital would result in more music being available to more people in more ways than ever before — ways that had never previously been imagined. Across all of the new and emerging distribution platforms (such as online, cable, wireless, and satellite) and all of the products and business models unforeseen less than a decade ago (such as ringtones, music videos on handheld devices, portable subscription music services, and satellite radio) there would be one commonality: the vibrancy and creativity of the music that makes all of these business models possible.

We meticulously rebuilt Warner Music Group to capitalize on the digital future. Central to our strategy was the decision to foster the development of new products and new business models. We have embraced the reality that our future success will not be built on returns from one product — the CD. We have cultivated multiple distribution methods, formats, and products, all of which derive from the creative efforts of our artists and record labels and all of which result in the increased availability of music to consumers. Today, WMG is no longer just a record company; it is a music-based content company, earning revenue from different digital models and products, including digital downloads of single tracks and albums, online subscription services, custom and non-interactive webcasting, streaming of music videos, downloads of music videos, and all forms of ringtones. We were the first major record company to offer music videos in the United States for download through a wireless carrier, and we were the first major record company to enter into a licensing agreement with YouTube, an innovative user-generated video site recently acquired by Google. In general, we are eager to enter into partnerships with innovative distribution platforms whenever we can receive the fair value of our music in those partnerships.

Our efforts are bearing fruit. Digital revenue was 11% of the company's total revenue in the second calendar quarter of 2006, more than double the percentage for the same quarter in 2005, and up from virtually nothing in 2004. Industry analysts predict that digital revenue will approach 20-25% of total record company revenue in 2008. As CD sales continue to decline industry-wide, digital revenue streams of all kinds are now essential to our company and represent the fastest growing segment of our business. That is why proceedings such as this are of critical importance to the music industry, both to recording artists and record companies.

II. Setting the Royalty Rates

As the discussion above makes clear, the recording industry is transforming itself in dramatic fashion and at a lightning-fast pace. The business model of the past — a stable, single source of revenue from physical sales — is rapidly being displaced. Success in this industry now depends on creatively identifying and harnessing multiple streams of revenue from a wide array of distribution, format and product possibilities. It is against this backdrop of profound transformation that the royalty rate issue for satellite services should be assessed.

In setting the royalty rates in this proceeding, I believe there are four points that are particularly important to the tribunal's deliberations.

A. *Royalty Rates Must be Based Upon Fair Value*

First, the focus of the rate-setting inquiry should be on the *value* of copyrighted sound recordings. That is how pricing for our sound recordings is set in the broader marketplace, and that is how the price should be set here. When consumers pay $13 per month for satellite radio, they do so principally because they want the music that is offered over XM's and Sirius's services. Music is the primary content on these services and is the centerpiece of the consumer offering. When WMG voluntarily provides its content to other parties for certain digital music services, we are compensated with a share of revenue that is orders of magnitude greater than the share of revenue that we now receive from satellite services.

The essential point that content providers should receive the value of the content they provide is perfectly illustrated by the numerous high-profile and highly publicized agreements XM and Sirius have entered into with Howard Stern, the National Football League, Major League Baseball, Martha Stewart, and others. XM and Sirius pay significant sums to these individuals and entities for the right to provide their content to subscribers. Given the substantial fees XM and Sirius have paid in the marketplace to obtain this content, there is no reason to think that these other content providers have discounted their prices because of the high costs XM and Sirius may have incurred to construct and operate their delivery systems. XM and Sirius have paid hundreds of millions of dollars to obtain such content because that is simply its value. XM and Sirius find this programming to be valuable (and hence are willing to pay for it) because they believe subscribers and potential new subscribers will pay a significant monthly fee to acquire access to it. XM and Sirius have paid for non-music programming based on its fair value in the marketplace.

As a matter of policy, the determination of content value should not depend upon how much a particular distribution service costs to build or operate. Cable companies and telecommunications companies have invested billions to install the infrastructure needed to deliver broadband to America's homes, yet they receive no discount from copyright owners for the programming they provide to subscribers via these networks. By the same token, record companies should not be required to accept below-market rates from one distributor simply because that distributor may have higher costs than those of a different distributor. Such an approach would undercut the position of the alternative distribution methods and unfairly penalize them for their comparative efficiency, thereby hindering the vibrant businesses that are developing for new paid uses of sound recordings. If the satellite services incurred their infrastructure costs anticipating that, because of those costs, they would receive discounted rates for content, that was a poor business decision. To reward them with discounted rates in this proceeding on the same theory would be a poor policy decision.

Our copyrighted sound recordings are absolutely indispensable to XM and Sirius. They would only be able to charge their subscribers a fraction of the amounts they currently charge if those services did not offer music — indeed it is highly unlikely that they would even have a viable business absent the music we provide. It is only appropriate that the royalty rates reflect that fact.

B. *Discounted Royalty Rates Would Act as an Unfair Subsidy for XM and Sirius*

Second, there is no justification for forcing the recording industry to subsidize XM and Sirius through rates that are less than fair value. Given the payment obligations that XM and Sirius have voluntarily undertaken for other non-music content, it is impossible for the record companies to agree that we (and no one else) should bear the brunt of all of XM's and Sirius's business decisions, which result, according to them, in having less money to pay for their flagship offering — music. After all, it was the recording industry that helped XM and Sirius initially launch their service and has provided their centerpiece content since inception. By entering into marketplace transactions with high fees for other content, XM and Sirius have recognized the economic value of content, and no content is more essential to their services than music. XM and Sirius should not be able to leverage our copyrighted sound recordings to establish their businesses and then put sound recording copyright owners and artists at the back of the line to receive fair compensation.

XM's and Sirius's desire to force the recording industry to subsidize them is especially pernicious given the long period over which the new rate will apply (six years), which minimizes the relevance of claims that XM and Sirius are not yet earning enough money. Investors in those companies recognize the prospects of a long-term payoff and have put their money in these companies with that in mind. The royalty rate that this tribunal imposes must account for the rapid growth of XM and Sirius and their enormous future earning potential over the entire term of the statutory license. The proposed approach of the record companies — royalties based upon a percentage of revenue — represents an appropriate accommodation of all the parties' interests over the six-year term. By taking this approach, the record companies are betting on the continued relevance of the satellite services. The revenue the record companies receive will grow as XM and Sirius become more successful over time. Conversely, if the satellite services do not achieve anticipated increases in subscribership, then our revenue will diminish as well.

Moreover, as a result of the rapidly changing distribution environment for music, our marketplace distribution deals are of far shorter duration (often only one to two years) than the statutory six-year license given to XM and Sirius. In the current climate, if there were no statutory license, WMG would not accept a satellite services distribution deal with a six-year term unless significant financial protections were built into the agreement. Accordingly, our percentage of revenue rate proposal — pursuant to which the record industry would ride, either up or down, with the fortunes of satellite services — is more than fair to the satellite services.

I want to be clear that WMG welcomes innovative services such as XM and Sirius. They are exactly the kind of new digital platforms that WMG embraces. Consumers benefit from the digital signal and the mobility of the transmissions (which the satellite services provide), and from the variety and quality of music available (which the record companies and artists provide). The satellite services and the sound recording copyright owners both contribute to the quality of the satellite music experience; both should get fair value for their contributions. The success of the satellite companies should not come at the expense of the recording industry. This is especially true given that non-music content providers are earning a fair market return from their deals with these services. Record companies want to be partners with services such as XM and Sirius (indeed, our suggested percentage of revenue rate proposal would make us *de facto* partners with these services), but that does not mean that, given the opportunity to do otherwise, we would agree to license our content for the rates that XM and Sirius appear to desire. In fact, WMG would rather pull its content from satellite services (if it had the option) than accept a royalty rate that does not fairly value our content.

C. *XM and Sirius are Neither "Radio" Nor Promotional*

Third, it is inappropriate to analogize XM and Sirius to traditional terrestrial radio. Indeed, the term "radio" is a misnomer for the services provided by XM and Sirius. XM and Sirius are full-fledged digital music services that make massive use of sound recordings, playing tens of millions of hours of music to millions of subscribers each week, while earning large subscription fees in return. They transmit high-quality digital sound, and they have a unique advantage (indeed a guaranteed duopoly created and protected by Congress) to provide digital satellite transmissions that afford the option of nationwide mobile reception — in the home, in the car or while traveling. They are able to offer consumers a dazzling array of channels, most built on works of artists discovered and nurtured by the record companies — the companies that financed the creation of the sound recordings and marketed those artists to the public. XM and

Sirius provide scores of narrowly themed programming channels that cater to the very particular tastes of an individual listener. For instance, they offer stations individually dedicated to each of the past six decades; stations with nothing but soundtracks, or nothing but show tunes; stations for "Early Classic Rock," "Late Classic Rock," and "Deeper Classic Rock"; and all manor of jazz and blues stations. There is even a station entitled "Hair Nation," dedicated to "80's Hair Bands." This type of extensive, specific, and highly targeted programming across dozens of channels is unheard of on traditional terrestrial platforms.

The characteristics described above make satellite services a far cry from traditional "radio." Above all, XM and Sirius give listeners significant control over the music to which they listen — which is of great value and replaces the need for some listeners to buy music in other forms. And they have made their services even more attractive (in comparison to traditional radio) through features such as "alert" functions that inform listeners when their favorite songs are playing and allow them to jump from channel to channel to listen to those songs.

Nor is it correct that satellite services should be analogized to traditional terrestrial radio on the theory that satellite play of sound recordings is "promotional" — that the exposure of listeners to music via XM and Sirius induces listeners to purchase more CDs or digital downloads. WMG does not consider XM and Sirius to be significantly promotional. We are not of the view that the availability of our copyrighted sound recordings on XM and Sirius stimulates sales, in any meaningful way on other paid distribution platforms.

For these reasons, we spend very little on so-called "promotional" activities involving XM and Sirius, as compared to the amounts we spend on "promotion" for traditional terrestrial radio. Indeed, in our judgment, the net effects of XM and Sirius on WMG and other record companies are likely to be more "substitutional" than promotional — the availability of music on

XM and Sirius is likely to *reduce*, rather than increase, the sales of our copyrighted sound recordings. In my judgment, because consumers have limited budgets for music and limited time to spend listening to music, the dollars they spend listening to music on XM or Sirius, and the time they spend doing so, reduce their willingness to spend money on our copyrighted sound recordings through other channels. Given the choice, WMG would not provide XM and Sirius with the right to transmit our copyrighted sound recordings at rates less then fair value based on a discount for claimed "promotion."

D. *The Satellite Royalty Rate Will Have a Profound Impact on the Recording Industry*

Fourth, it is critical to understand that the royalty rate set in this proceeding will have a significant effect not merely on XM and Sirius, but on record companies and artists as well. The success of WMG's business model depends on receiving fair value for our music from *all* distribution channels. To be sure, satellite services provide only one of the revenue streams on which WMG's future success depends. But given the projections for their growth, XM and Sirius promise to be a popular music destination, and therefore a significant revenue source (provided that we receive fair value for our music). The establishment of a fair rate for these and other services will be critical to the record industry's effort to offset the rapidly declining revenue from CD sales over time.

Because the term of the statutory license is six years, the royalty rate chosen by this tribunal is certain to have significant direct effects on the ability of WMG and other record companies to weather the dramatic upheavals in traditional business models, and to succeed in the new reality of multiple digital platforms. And if the tribunal sets rates at less than fair value, such a ruling may inflict harms on record companies that extend well beyond the reduced revenue from XM and Sirius. Such discounted rates could put downward pressure on other distribution deals negotiated in the marketplace, as distributors insist that the rates set in this proceeding serve as a benchmark for pricing alternative digital services, and could also adversely affect other compulsory license rates. The royalty rates record companies receive in this proceeding are in no sense ancillary or unimportant to record companies' future business prospects. To the contrary, it would reflect an outmoded (and soon to be irrelevant) understanding of market realities to determine a rate for satellite services on the notion that revenue from satellite services will be merely incidental to record companies. Ultimately, revenue from services such as XM and Sirius *are* the future of the industry, and only by receiving fair compensation from such services will the record industry be able to thrive and continue to create the music that is so important to the lives of so many people around the world.

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

Edgar Bronfman, Jr.

Date: 10/29/2006