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

REBUTTAL TESTIMONY OF

CHARLES CIONGOLI

Executive Vice President and Chief Financial Officer
Universal Music Group North America

Public Version

July 2007

WRITTEN REBUTTAL TESTIMONY OF CHARLES CIONGOLI

Background and Qualifications

I am Executive Vice President and Chief Financial Officer for Universal Music Group North America ("UMG"), a position I have held since 2003. I am responsible for the financial activities of UMG's North American operations, which include nine United States record label groups, as well as music publishing, selling, and distribution operations. In my capacity as Executive Vice President and Chief Financial Officer, I have knowledge of and regularly review the finances of both UMG's U.S. record label and the music publishing operations of Universal Music Publishing Group ("Universal Publishing").

I was previously Senior Vice President of Finance for UMG. Prior to that, I was employed as Vice President of Finance for MCA Records, and also served as Vice President and Group Controller for both MCA Records and MCA Music Publishing. I began my employment with MCA in 1990 as the Group Controller for the MCA Music Entertainment Group, which became UMG in 1996. Prior to joining MCA in 1990, I was a Senior Manager with the international accounting and consulting firm Price Waterhouse, where for ten years I provided a variety of audit, accounting and special services for Mergers and Acquisitions.

I received a Bachelor's degree in Finance and Auditing from California State University at Northridge. I am a Certified Public Accountant (CPA) in the State of California, and I am a member of the American Institute of Certified Public Accountants and the California State Society of CPAs.

Universal Music Group and Universal Music Publishing

UMG is the largest record company in the world with over a 31% share of the domestic recorded music market in 2006. It consists of numerous acclaimed and popular record labels, including Motown Records, Universal Records, Geffen Records, Interscope Records, MCA Nashville, Island Records, and Def Jam Music Records.

Universal Publishing recently completed the acquisition of BMG Music Publishing which, as a result, has made Universal Publishing the largest publishing operation in the United States and the world, with a combined U.S. market share of approximately 20-24%.

Overview

I am submitting this testimony to provide the Copyright Royalty Judges with information concerning the sound recording and music publishing businesses, which operate separately at UMG but which each report their finances through me.[1] As part of this testimony, I am providing comparative financial data on UMG's U.S. record label and Universal Publishing's music publishing operations. For purposes of this comparison, I have excluded all BMG Music Publishing financial data, as it is not applicable for 2006 and prior years. To assist the Judges, I have attached copies of UMG's Consolidated U.S. Record Label Income Statements for 1999 through 2006 (SX Ex. 213 RR) and Universal Publishing's U.S. Music Publishing Income Statement (SX Ex. 214 RR) as exhibits to this written testimony. I have reviewed these documents in preparing this testimony, and I regularly review such materials in the ordinary course of my professional responsibilities.

---

[1] I understand that in Docket No. 2006-1 CRB DSTRA and Docket No. 2005-5 CRB DTNSRA, XM Satellite Radio Inc., Sirius Satellite Radio Inc. and MTV Networks (collectively, "the Services") have proposed benchmarks based on the royalty rates for musical works paid to performance rights organizations such as ASCAP, BMI and SESAC. I submit this testimony to rebut the Services' testimony proposing those benchmarks.

As discussed in more detail below, there are fundamental differences between the sound recording and music publishing businesses. They play very different roles in the sale of music and also vary greatly in terms of the magnitude of the investments required and the level of risk associated with those investments.

There is little consumer market for musical works by themselves (e.g., as sheet music). The actual products that consumers buy and to which they listen are sound recordings, and musical works are one component of sound recordings. The sound recording is created, marketed, and distributed by the record company. While music publishers earn royalties from the sale of sound recordings (e.g., on CD and as digital downloads and mastertones) and music videos, they invest very little. Although they do have to pay advances against royalties to songwriters (or their publishing designees), music publishers are able, to a large degree, to ride the coattails of the record companies. Unlike record companies, music publishers do not incur significant recording, marketing, promotion, sales, distribution, creative services, video, new technology, or personnel costs. Rather, it is the record companies that expend enormous sums to create and promote their products to consumers. The publishers are the beneficiaries of the record companies' work and investment.

It is therefore unsurprising that the risks and rewards -- and the levels of compensation -- for sound recordings and musical works differ greatly in markets where music is disseminated. I have frequently heard the sound recording business described as being like the stock market -- high risk, high reward -- and the music publishing business described as being like the bond market -- low risk, consistent but lower returns. I agree with that characterization.

The sound recording business is risky and speculative. A record company invests large sums of money before a final product is created. Once created, the record company must then

undertake great expense and effort to market and promote the sound recordings, with the hope that it can earn back its substantial upfront investment. In reality, the vast majority of sound recordings are not profitable for record companies; for each record that earns a profit for a record company, there are approximately nine others that do not.

The music publishing business, by contrast, is much less risky. Unlike the sound recording business, the music publishing business is not fundamentally about creating a product. To a certain extent, then, the music publishing business resembles a bank. When music publishers invest in the acquisition of catalogs of musical works, their decision to invest is based on the catalog's proven value. In general, the music publisher knows what the catalog has earned in the past, and is investing in an income stream for the future based on past performance, primarily from sales of CDs or downloads and performances on over-the-air broadcasts, and use in motion pictures and television advertising. Music publishers may also invest in musical works that do not have a proven track record, but generally do so only where a record company previously has signed the recording artist/songwriter to a recording agreement and has made clear that it will be spending significant sums to develop, promote, and market sound recordings by that recording artist/songwriter, all of which will help to ensure revenue from those musical works. Thus, a music publisher will give a significant advance to a new singer-songwriter only if it knows that a record company is going to spend far greater sums to promote that artist.

For all of these reasons, the music publishing business is materially different in character from the sound recording business.

Comparison of Investment, Risks, and Operations of Sound Recording and Music Publishing Businesses

As I discuss below, UMG's record label operations are characterized by a greater level of investment and risk than Universal Publishing's music publishing operations. Record labels

engage in a very risky business that requires substantial expenditures for recording costs, overhead, marketing, promoting, manufacturing and distributing sound recordings. For most sound recordings, the majority of the costs are incurred before a single unit is sold. By contrast, the publishing business involves less risk and less cost. Universal Publishing spends little or nothing to create, market, promote, manufacture and distribute copyrighted musical works. Moreover, the music publishing business benefits from the record company's marketing, promotion and other efforts, which help generate mechanical royalties and public performance royalties that publishers and songwriters receive. Further, when a record company makes a sound recording a hit, music publishers are able to garner significant license fees for synchronization uses of the sound recording. The greater costs and upfront investments make the recorded music business less profitable and much riskier than the music publishing business. These differences in investment characteristics also reflect one of the reasons for the greater return generally provided to sound recording copyright owners than musical works copyright owners.

Before I discuss the different types of investment, I must note that the distinct and interrelated finance and accounting concepts of costs, expenses, investments and cash expenditures are often conflated in general discussion. For present purposes, the technical distinctions among those terms are not instructive. Accordingly, my testimony uses the term "cost" broadly to give the Judges an instructive sense of the financial scope of UMG's and Universal Publishing's businesses.

A. Artist and Repertoire ("A&R") Investment

The creation or acquisition of copyrighted works that generate income requires both the recorded music and music publishing operations to incur expenses in acquiring the services of

artists and songwriters. Record companies and music publishers both pay advances, which they hope to recoup from future earnings. Despite these apparent similarities, however, expenditures on A&R are vastly different in the sound recording and music publishing businesses. Record company investments in A&R include all of the work that goes into finding and developing talented artists and bringing the product (i.e., the sound recording with its underlying musical work) to market, including paying for advances and recording costs. Record companies advance large amounts of money to artists and pay for all of the recording, producing, mixing, mastering and other expenses involved in creating a sound recording. Some expenditures are not recoupable at all because with a large percentage of artists, record companies never recoup the given advance.

In contrast, music publishers spend little to create the product that is sold to consumers. They do provide advances to songwriters, but those advances are generally smaller and are wholly recoupable by the publishers. Moreover, music publishers often pay advances to songwriters who already have revenue in the pipeline either from sales of proven catalog tracks or recently released albums that have sold but for which royalties have not yet been paid. Overall, then, the risk of investment falls almost completely on the record company.

The dramatic difference in the two businesses can be seen by looking at the data regarding their investment in A&R. Gross A&R expenditures for UMG's record labels and Universal Publishing show that the sound recording business requires a significantly greater investment (and thus a significantly greater return to make it profitable) than the music publishing business. In 2006, UMG's record labels had gross A&R expenditures of [ ]. In marked contrast, Universal Publishing's gross A&R expenditures were [ ] for the same time period.

On UMG's income statements for both the record label and music publishing operations, we report a line item for total A&R costs. This line item reflects net A&R investment and therefore refers to the amount of unrecouped advances and recording costs to artists and songwriters paid or expensed in the relevant period. As shown in SX Ex. 213 RR and SX Ex. 214 RR, the net A&R expense for UMG's record labels in 2006 vastly exceeded Universal Publishing's net A&R expense for the same time period. As shown in Figure 1 below, UMG's record labels had net A&R expense of [[redacted]], or [[redacted]] of our labels' FY 2006 total net revenue. The comparable data for our music publishing operations are a net positive of [[redacted]] of net revenue for FY 2006.

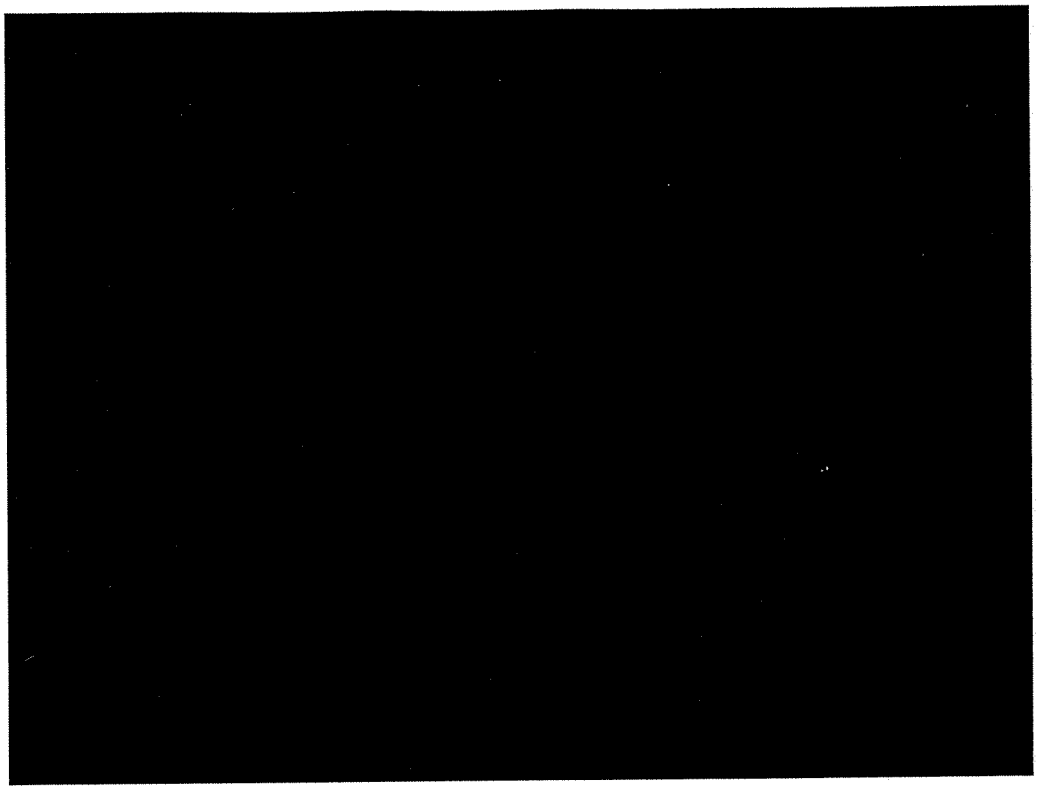
[redacted]

Note that these figures do not include overhead -- i.e., the cost of personnel to engage in A&R activities. The A&R staffs of record companies are much larger than those of music publishers and significantly more expensive. These A&R overhead expenses are included in the "overhead" category discussed below.

B. Marketing Costs

UMG's record labels market and promote their new albums and artists to consumers in order to achieve sales. The investment in marketing includes the cost of music videos, print advertisements, television advertisements, point of purchase advertising materials, co-op advertising, radio advertising, Internet advertising, promotional merchandise, and a host of other expenses. Most of these marketing costs are incurred up front, before the record company is able to generate any revenue from the music that is being marketed. These expenditures -- if successful -- benefit both record companies and music publishers, who each earn revenues when a particular artist, song, or album becomes popular.

By contrast, Universal Publishing generally does not have to undertake much in the way of marketing efforts. It simply relies on the record company to do the bulk of the marketing. Accordingly, the marketing costs incurred by the recorded music businesses are substantially higher than the marketing costs incurred by the music publishing operations. As SX Ex. 213 RR demonstrates, in FY 2006, UMG record labels spent a total of [ ] of their total net sales, on marketing. Universal Publishing, on the other hand, does not even have a separate line item for marketing. If, however, one totaled all of the publicity, promotion, and travel and entertainment expenses, it would total [ ] of its total publishing income in FY 2006. *See* SX Ex. 214 RR. Figure 2 below shows the comparison.



Once again, none of these figures includes overhead, discussed below, which is vastly greater in the recorded music business because of the personnel required to conduct all of the marketing and other promotional activities that form no part of the music publishing business.

C. Overhead

UMG's record labels have much larger overhead expenses than Universal Publishing because, as I have discussed above, the labels must undertake many more activities. Overhead expenses include, for example, salary and benefits, office space, supplies, utilities, office equipment, furniture, and travel and entertainment costs. The extent of these costs is largely driven by the number of personnel involved in an operation. Because UMG's recorded music operations have a greater need for personnel than Universal Publishing, UMG incurs greater overhead expenses. UMG requires personnel to do all of the work in finding, developing, promoting, and marketing sound recordings -- work from which music publishers benefit without cost. As SX Ex. 213 RR shows, UMG's record labels had overhead expenses (excluding

overhead for selling and distribution, discussed below) in FY 2006 of [ ] of net sales. By comparison, Universal Publishing had overhead costs of [ ] of total revenues for FY 2006. *See* SX Ex. 214 RR.

D. Manufacturing and Distribution Costs

UMG's record labels also must pay significant manufacturing costs in order to produce the physical product that is sold to the customer. Manufacturing costs are incurred before sales are made to customers, and with no guarantee that they will be recovered from sales. In FY 2006, UMG's record labels incurred [ ] in manufacturing and inventory related costs. *See* SX Ex. 213 RR. Another substantial expense incurred by UMG's record labels is the cost of distributing their sound recordings to retailers and consumers. In FY 2006, UMG's record labels spent [ ] on distribution and selling expenses (including overhead). *See* SX Ex. 213 RR.

The transition to more digital distribution of sound recordings does not mean that record companies' manufacturing and distribution costs have disappeared. Rather, record companies must maintain two separate (and expensive) chains of distribution -- incurring all of the costs of digitizing sound recordings, collecting and updating metadata, building and operating systems for distribution, and actually distributing digital versions of sound recordings to retailers and other outlets. These costs include the investment in IT for system development, the cost of labor related to the housing of data and other digital assets, and other expenditures. In addition, record companies must maintain all of the relationships with the ever-growing number of outlets selling digital and mobile music in various forms. All of these expenses are encompassed within distribution expenses or overhead expenses. All told, UMG's manufacturing and distribution costs for 2006 were [[redacted]] of net sales. *See* Figure 4.

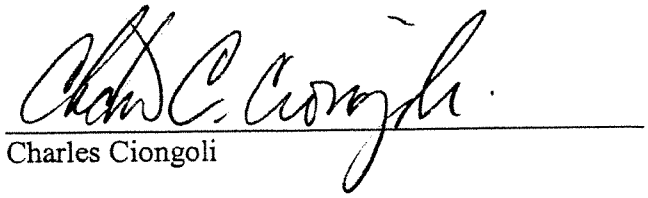
Music publishers, in most cases, need not undertake any of these activities because they are not providing a product directly to retailers or consumers. Universal Publishing earns revenue from licensing its musical works. It does not manufacture physical products and thus incurs no manufacturing costs at all. Universal Publishing therefore has no budget line item for this cost category and takes none of the risks associated with producing a physical product. Similarly, Universal Publishing does not incur distribution costs and thus has no line item for those costs, nor does it incur separate expenses for digital and mobile activities.

[redacted]

Conclusion

As the foregoing discussion and data make clear, the character of the sound recording business is markedly different from the music publishing business. UMG's record labels incur much greater cost in creating sound recordings than Universal Publishing incurs in creating musical works. Music publishers, including Universal Music Publishing Group, benefit from the creation of sound recordings by record companies and earn revenues from the efforts of record companies without having to engage in the same type of investments. At the same time, there is substantially more risk associated with UMG's recorded music operations than with Universal Publishing's music publishing operations.

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



Charles Ciongoli

Date: July 24, 2007

Exhibits Sponsored by Charles Ciongoli

Restricted exhibits, which are identified by the suffix "RR," are not included in the Public Version of SoundExchange's Rebuttal Case

Exhibit No.	Description
SX Exhibit 213 RR	Universal Music Group US Only Income Statement, 1999-2006 Actuals
SX Exhibit 214 RR	Universal Music Publishing Group, US - Publishing, Full Year Historical Results and Historial Overhead Expense, 1999-2006