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

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Public Version

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Rebuttal Testimony of Michael Pelcovits

I am a Principal with Microeconomic Consulting & Research Associates, Inc. ("MiCRA"). I previously provided a written direct statement in this proceeding and my background and qualifications as an expert are included with that testimony. I provide this statement to respond to a number of points made by XM Satellite Radio Inc. ("XM"), Sirius Satellite Radio Inc. ("Sirius"), and MTV Networks ("MTVN") (collectively, "the Services") through Dr. Tasneem Chipty and Michael Bloom.

The Services present two very different rate proposals. XM and Sirius have jointly proposed only a per-subscriber rate of $0.001235 per subscriber per month. By contrast, MTVN has not proposed a rate at all. Rather, it has proposed only a cap or upper bound of "no more than 5 - 7.25% of revenue" attributable to the service. Both proposals, however, are based on or derived from the same two purported "benchmarks." The first is the payments made by the Services and others to ASCAP, BMI, and SESAC for musical works rights. The second is the sound recording performance rate arrived at in 2003 for the pre-existing subscription services ("PSS"). Neither of these benchmarks is suitable for purposes of establishing a royalty fee for the sound recording performance right at issue in this proceeding. I will explain my reasons for this conclusion in the following two sections of this rebuttal testimony. Following that discussion, I will address certain changes to SoundExchange's rate proposal and to the analysis in my written direct testimony that I have made in response to the Services' direct cases.

1. Musical Works Benchmark

Through their economic expert Dr. Chipty, XM and Sirius propose three different benchmarks, all of which are rates derived from royalty payments made to the performance rights organizations ("PROs"). They are: the combined rate that Sirius pays for musical works to ASCAP, BMI and SESAC[1]; a derived combined rate that Music Choice would pay for musical works to ASCAP, BMI and SESAC that is extrapolated from a rate recently set for Music Choice and BMI[2]; and a derived combined rate that Music Choice would pay for musical works to ASCAP, BMI and SESAC that is extrapolated from a rate for Music Choice and BMI set in 2001.[3] Dr. Chipty reasons that sound recordings and musical works have the same or similar values and states that she is "aware of no evidence that there is a difference in the value of these rights across an entire library of songs."[4] Similarly, she argues that the sellers of the two rights are in the same position because "the only relevant costs" associated with the two rights is the same (zero).[5] She implies that marketplace transactions between the buyers and sellers of the two performance rights would yield similar royalties. Indeed, Dr. Chipty argues that the PRO payment should serve as an upper bound for the sound recording performance right, as a result of a combination of market-based and 801(b) factors.

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[1] Written Direct Testimony of Tasneem Chipty ("Chipty WDT"), ¶¶ 32-33.
[2] *Id.*, ¶ 34.
[3] *Id.*, ¶¶ 35-38. Oddly, Dr. Chipty identifies this third benchmark as the 1998 rate of 6.5% set by the CARP and the Librarian at which the PSS would pay SoundExchange for performances of sound recordings. *Id.*, ¶¶ 35-36. Yet, she does not actually propose a benchmark of 6.5%. Rather, she proposes a benchmark of [[redacted]]% which she explains as a derived total of what Music Choice was at that time paying ASCAP, BMI and SESAC for musical works. *Id.*, ¶¶ 36-38 & n.46. As Dr. Chipty herself explains, her [[redacted]]% benchmark actually has nothing to do with any rate for the performance of sound recordings. *Id.*, ¶¶ 37-38.
[4] *Id.*, ¶ 29.
[5] *Id.*, ¶ 30.

For its part, MTVN proposes 5% as the lower bound of its proposed rate range, based on what it understands to be the current musical works performance rate available to it from the PROs.[6]

The Court should reject use of the musical works benchmark in this case for the same reasons that it rejected this benchmark in the webcasting case. In the webcasting case, the Court found that "substantial empirical evidence shows that sound recording rights are paid multiple times the amounts paid for musical works rights ...."[7] The Court also rejected Dr. Jaffe's (the webcasters' expert) reliance on sunk cost as a justification for using the musical works benchmark. Finally, the Court found that "there is ample empirical evidence to controvert Dr. Jaffe's premise that the market for sound recordings and the market for musical works are necessarily equivalent."[8]

Dr. Chipty (and certainly Mr. Bloom, who offers no analysis at all) fails to account for or explain the abundant evidence from the marketplace that the two different rights are valued differently. Indeed, Dr. Chipty claims to be aware of no such evidence. As I explained in the webcasting case and as Mr. Eisenberg explains in his rebuttal testimony here, however, that evidence is compelling. Sound recording copyright holders receive royalties several times greater than the royalties paid to musical works copyright holders. This relationship between the values of the two different rights is a fundamental aspect of the market that cannot be ignored or explained away as an anomaly or artifact. Simply put, Dr. Chipty is demonstrably wrong.

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[6] *See* Written Direct Testimony of Michael Bloom ("Bloom WDT"), ¶ 12.
[7] Docket No. 2005-1, *Digital Performance Right in Sound Recordings & Ephemeral Recordings* ("*Webcasting II*"), 72 Fed. Reg. 24,087, 24,094 (May 1, 2007).
[8] *Id.* at 24,095.

Dr. Chipty first argues that the relevant cost in a negotiation for sound recordings or musical works both would be zero or near zero.[9] To get there, she claims that costs incurred by the recording companies and by the publisher going forward may provide an upper bound, but largely are irrelevant because the record companies would make the same recordings going forward regardless of whether they ultimately negotiated licenses with the Services.[10]

This argument is entirely unsupportable. The rates set in this proceeding will be applied through 2010. For any new sound recordings created between the time the rate is set and 2010, the record companies will incur incremental costs -- that is, costs that are not already sunk. Because the record industry earns the majority of its revenues from recently released albums,[11] it is reasonable to expect that much of the music played by the Services after this rate is established will be newly-created sound recordings. The Court, therefore, is setting a rate that will affect how much the record companies earn for the use by the Services of new sound recordings for which costs are not yet sunk.

In turn, Dr. Chipty contends that, even if the creative costs of sound recordings and musical works are not sunk, they remain irrelevant to a willing-buyer-willing-seller negotiation because the record companies would make the same investment in the same future sound recordings, regardless of whether they were licensed to the Services. The economic reasoning behind this argument is flawed. A business will not be indifferent economically about how much revenue it can earn from a service (and how much of its

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[9] Chipty WDT, ¶ 30.
[10] *Id.*, ¶ 12.
[11] According to information released by Nielsen SoundScan and Nielsen BDS, more than half of all sound recordings sold in the U.S. are "current" or new releases, i.e., sound recordings released in the last two years. *See* Business Wire, *Music Industry Report, New Radio Star*, available at http://newradiostar.com/NEWS/MUSICINDUSTRYREPORT2003.htm (last visited Sept. 27, 2006).

costs it can recover), simply because the business *might* be able to recover its costs through other -- competing -- revenue streams. Rather, a rational business will consider each opportunity to increase revenues and cover a portion of its costs as worthwhile in its own right. So long as the business does not have to incur a transaction cost that offsets the benefit of charging what would otherwise be a profit-maximizing price, it will attempt to do so.

With respect to the sale of sound recordings for use by the Services, it is nonsensical to say that the copyright owners would not insist on recovering a portion of their costs through all potential licensees. Indeed, this is especially true here, because the record companies understand that the market for the sales of physical products such as CDs -- long their primary source of revenue -- is steadily eroding, and the digital distribution of music through the Services and other digital distribution channels is what they must increasingly look to for their cost-recovery and profits in the future.[12]

More fundamentally, the Services ignore the structure of the markets that they are looking at and the relationships that define these industries. Although there are separate licenses at issue -- one for the musical work and one for the sound recording -- there is only one final product that is actually provided to the Services and to their customers -- the sound recording. As fleshed out in the rebuttal testimony of Charles Ciongoli, the structure of the market for music is one in which record companies invest in the creation, development, and marketing of sound recordings from which both record companies and music publishers would benefit. Music publishers earn the vast majority of their revenues from sales or licenses of sound recordings that use musical works as an input, not on sales

[12] *See* Written Direct Testimony of Lawrence Kenswil, Docket No. 2006-1 CRB DSTRA, Oct. 30, 2006, at 2-3; Written Direct Testimony of Mark Eisenberg, Docket No. 2006-1 CRB DSTRA, Oct. 30, 2006, at 4-5; Written Direct Testimony of Edgar Bronfman, Docket No. 2006-1 CRB DSTRA, Oct. 30, 2006, at 3-5.

or licenses of musical works by themselves. Therefore, even though the music publishers hold a right separate from the sound recording copyright (a right for which, in many cases, the user must negotiate separately), the value of this right is not arrived at independently in the market. Moreover, any attempt by the music publishers to extract an equal payment for its right will not succeed in the long run, unless the long run value of its input is as great as all other inputs combined.

2. PSS Sound Recording Royalties Should Not Serve As A Benchmark

MTVN -- but not XM and Sirius -- also argues that the unadjusted PSS royalty is an appropriate upper bound benchmark for what the Services' royalty ought to be here. The PSS rate is not an appropriate benchmark, for several reasons. First, the PSS royalty is not a market rate. Rather it reflects a settlement among the parties in 2003 to carry forward a 1998 rate set by the CARP, with a small upward adjustment. The 1998 rate, moreover, was not based on market rates for sound recording performance rights, but rather for musical work performance rights.

The PSS rate thus reflects a litigation settlement, and therefore reflects the parties' judgments on many issues, including the high costs of litigation relative to the small amount of revenues generated by the entire PSS industry. It is not a market rate. Moreover, the PSS rate reflects the 801(b) factors, whereas this case is governed by the willing-buyer-willing-seller standard. This too argues against using the PSS rate as a benchmark. Instead of reflecting a market value, the negotiated PSS rate reflects both market and regulatory expectations as well as litigation risks. MTVN makes absolutely no attempt to disentangle

the PSS parties' predictions of how the Court might have ruled on the 801(b) factors in 2003 and then to apply this insight here.

Nor is it possible to disentangle this settlement rate to find the rate that willing buyers and willing sellers would agree to in a market free from regulatory compulsion. To the extent that the parties believed that a CARP in 2003 would not have made significant changes to the rate set by the Librarian in the prior proceeding, they may have determined simply to use the prior decision as a starting point in the negotiations. But such an approach is very different from a marketplace negotiation of the type to be simulated under the willing-buyer-willing-seller standard. Moreover, the underlying 1998 decision itself used musical work rights as the basis for its starting point. As this Court has recognized, the value of these two rights is very different in the marketplace. For these reasons, the PSS rate is useless as a benchmark.

3. The SoundExchange Rate Proposal

In my direct testimony, I argued for a rate of 30% of revenue with a per-subscriber minimum of $0.25. I based that proposal on my proposal in the webcasting case, Docket No. 2005-1 CRB DTRA. Based on the best available -- though limited -- information at the time, noninteractive webcasting (adjusted from interactive webcasting) seemed like the most analogous market setting from which to derive the appropriate rate for the noninteractive Service here, considering in particular the fact that listeners to both types of services are tethered to a non-mobile device (a computer in the case of webcasting, a television in the cases of the Services) and that both types of services are noninteractive. After reading the Services' direct cases, it remains my view that noninteractive webcasting

is a better benchmark than any of the Services' PRO royalty benchmarks although I concede that the information comparing consumer valuation of the Services to that of noninteractive webcasting remains quite limited and imperfect. Therefore, I believe that my original analysis requires modification to account for the lack of good information on consumer valuation.

It is challenging to identify an appropriate benchmark market for these Services because of the characteristics of the target market itself. There are only five participants in this market. Of those, two -- Music Choice and to the extent it remains in the market at all, Muzak -- are PSS that are subject to the 801(b) statutory regime and for that reason give rise to poor benchmarks. Moreover, because the PSS never were participants in this proceeding, the terms of their contracts, marred as they are by the influence of the statutory standard, are not available. Two other participants in the market -- XM and Sirius -- have contracts that even their own expert admits are not useful benchmarks.[13] That is because XM and Sirius did not enter into their contracts to maximize revenue from the music services provided to satellite television. Rather, [ ].[14] Without a way to measure that value accurately, the contracts provide little information about the value of the service or about the value of the music over satellite and cable television. The fifth and newest entrant -- MTVN -- is the only willing-buyer-willing-seller participant in the market that seeks to

[13] *See* Chipty WDT, ¶ 39.
[14] *See* Chipty WDT, ¶ 24-26.

maximize profits in this line of business. As I discuss in more detail below, however, in all but two of its contracts with cable television providers, the digital audio radio service, which MTVN has called "Urge Radio," is bundled with the family of popular MTVN cable television channels.[15] This, again, makes it extremely difficult to use the contracts for benchmarking purposes.

I therefore continue to believe that the best benchmark market remains noninteractive webcasting, despite some obvious differences between the two sets of services. Both sets of services are noninteractive. Both are non-portable. Both are all or virtually all music or other sound recordings that are preprogrammed by the licensee and subject to the statutory license. One is streamed to a computer; the other is streamed through a television set.

As a result, and for lack of a better suggestion by the Services, I continue to propose that the Services should pay a revenue share of 30% to the sound recording copyright owners based on the webcasting benchmark that I discussed on my direct testimony. Because this rate is a percentage of revenue, it adjusts to the revenues that the new subscription services actually receive and thus can adjust, to some extent, to the fact that there is little consumer demand for these services. In addition, a rate equal to 30% of revenue is within the range of percentages of revenues that are commonly received by record companies in the marketplace, as I noted in my webcasting testimony. In its webcasting decision, this Court noted that the types of compensation received by record companies in these other licenses are "of some general corroborative value."[16] Those agreements provide similar support for the 30% rate here as well.

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[15] *See* Proposed Amended WDT of Michael Bloom, ¶ 12.
[16] *Webcasting II,* 72 Fed. Reg. at 24,092.

The per-subscriber minimum aspect of the original rate proposal is a different story altogether. As an initial matter, the need for a two-part "greater of" rate structure is especially important in this market. Because there are market participants who are not trying to maximize revenue, a per-subscriber minimum is essential; otherwise, record companies would receive virtually nothing for the use of their sound recordings. Because, however, there is so little data concerning prices and potential revenues in this market, a percentage of revenue is also essential. Changes in technology or consumer practices (such as increased use of supplemental speakers for a home theater) could make these Services more valuable over the term of the license and, in the event of such an occurrence, the percentage of revenues may help ensure that record companies and performers are not undercompensated.

However, based on evidence produced in discovery, I now believe that the $0.25 per-subscriber minimum that I proposed in my direct testimony and which I derived from an attempt to estimate the value of the Service to retail consumers is not likely to reflect properly a market rate and cannot be tested against any direct evidence on consumer valuation. Moreover, the only observable marketplace transaction, albeit at a wholesale level, occurs at a price well below the price implied by the $0.25 per-subscriber minimum royalty fee, which I recommended in my direct testimony. Furthermore, since the percentage of revenue will be applied to a wholesale price, it would seem reasonable to base the per-subscriber minimum on transactions occurring at that same wholesale level.

As noted above, the XM and Sirius marketing contracts with DirceTV and DiSH Network tell us nothing about the revenue that a profit-seeking participant in this market

would make. And Dr. Chipty agrees.[17] Thus, the only useful contracts in the record in this proceeding are the contracts between MTVN -- the only profit-seeking market participant in this proceeding -- with its various cable customers. Documents produced by MTVN show that, as of the date of its production in this proceeding, it had contracts for its Urge Radio service with [[redacted]] different cable carriers. I have reviewed those contracts. In [[redacted]] of those, the cable carrier pays one monthly rate for a bundled family of MTVN cable channels, including the Urge Radio service. No separate rate for the Urge Radio service is given in the contracts. And, although MTVN apparently performs an internal allocation of those rates to the individual channels, including Urge Radio, I do not have any understanding of the bases for those allocations.[18] An internal allocation of revenues from a bundled contract does not have to correspond to how the prices for the components of the bundle would be set in a market. Accordingly, I would not feel comfortable relying on those allocations as any indication of what the market is in fact willing to pay for the Urge Radio service.

In two of MTVN's contracts, however, the Urge Radio service is broken out and separately priced. Those two agreements are with Everest Connections, LLC (SX Ex. 201 RR) and Grande Communications Networks, Inc. (SX Ex. 202 RR).[19] The table below shows the escalating rates that MTVM receives under these contracts for its Urge Radio service on a per-subscriber, per month basis, and a row showing the average of the two rates in each year:

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[17] Chipty WDT, ¶ 39.

[18] In his testimony, moreover, Michael Bloom, MTVN's only witness, had no idea about and could not explain the reasons for the allocations or the bases on which they were made. *See* Tr., July 19, 2007, at 26, 35, and 60-61 (Bloom testimony).

[19] *See also* Proposed Amended WDT of Bloom at 2 (identifying Grande and Everest as two of MTVN's first Urge Radio customers).

	2006	2007	2008	2009
Everest	[ ]	[ ]	[ ]	[ ]
Grande	[ ]	[ ]	[ ]	[ ]
Average	[ ]	[ ]	[ ]	[ ]

Even these two freely negotiated contracts are not perfect benchmarks. [ ]. I cannot tell what if any impact these covenants might have on the value of the contracts or how they might affect the value of the Urge Radio service. Nevertheless, these are contracts that were freely negotiated in the marketplace between willing buyers and willing sellers and there is no reason to assume that MTVN was trying to get anything other than the most money it could extract out of the cable companies. And they are by far the best evidence that has been produced in this proceeding.

These MTVN contracts also show that Dr. Chipty was simply wrong when she assumed, based on publicly available data, that a "Music Choice-like service should earn … $0.0233 per subscriber per month in 2006."[20] Indeed, I now have empirical evidence in actual contracts that a real "Music Choice-like service" -- the only profit-seeking Music Choice-like service in this proceeding -- was contracting for almost precisely [ ] times that amount in 2006. Accordingly, the revenue base that Dr. Chipty uses for the per-subscriber rate she proposes is [ ] times too low in 2006, and sinks even lower as the rate term progresses toward 2010. And, although rates in the market may vary, it is very unlikely that MTVN even would be in the market if other market participants were offering a

[20] Chipty WDT, ¶ 44.

substitutable service at [ ] the price or less. Dr. Chipty's assumption simply has to be wrong.

Based on this evidence, I propose a monthly per-subscriber minimum fee[21] for the Services, as follows:

2006	2007	2008	2009	2010
$.071	$.078	$.086	$.095	$.105

For 2006-2009, this is based on [ ]. For 2010, I have extrapolated based on the trajectory of the annual increases in the MTVN contracts from 2006 through 2009.

This concludes my testimony.

[21] The Services are unable to track listening and thus it is not possible to set a per-performance rate for the Services.

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

Michael D. Pelcovits

Date: July 24, 2007

Exhibits Sponsored by Michael Pelcovits

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 201 RR	MTVN agreement with Everest Connections, LLC
SX Exhibit 202 RR	MTVN agreement with Grande Communications Networks, Inc.