

Before the
COPYRIGHT ROYALTY JUDGES
LIBRARY OF CONGRESS
Washington, D.C.

In the Matter of

Mechanical and Digital Phonorecord Delivery Rate
Adjustment Proceeding

Docket No. 2006-3 CRB DPRA

**PROPOSED FINDINGS OF FACT
OF NATIONAL MUSIC PUBLISHERS' ASSOCIATION, INC.,
THE SONGWRITERS GUILD OF AMERICA, AND
THE NASHVILLE SONGWRITERS ASSOCIATION INTERNATIONAL**

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National Music Publishers' Association, Inc. ("NMPA"), the Songwriters Guild of America ("SGA") and the Nashville Songwriters Association International ("NSAI") (collectively, the "Copyright Owners") respectfully submit their Proposed Findings of Fact in support of their proposal for rates and terms for mechanical royalties under Section 115 of the Copyright Act.

I. Introduction and Summary

1. This proceeding—the first contested one of its kind since 1980—will determine the mechanical royalty rate paid to songwriters and music publishers for the reproduction and distribution of their musical works in physical phonorecords, permanent downloads and ringtones through 2012, pursuant to the compulsory license provision of the Copyright Act.¹ 17 U.S.C. § 115.

2. Under Section 801(b), the Court is obligated to set mechanical royalty rates that are calculated to (A) maximize the availability of creative works to the public; (B) afford the copyright owner a fair return for his creative work and the copyright user a fair income under existing economic conditions; (C) 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 (D) minimize any disruptive impact on the structure of the industries involved and on generally prevailing industry practices. 17 U.S.C.

¹ As discussed below in more detail, the Copyright Owners believe that ringtones are not within the parameters of Section 115, and have appealed an October 16, 2006 decision of the Register of Copyrights, which held that that ringtones that are merely excerpts of a preexisting sound recording fall within the scope of the statutory license.

§ 801(b)(1). As this Court recently held, it is appropriate for the Court to begin with a consideration and analysis of marketplace benchmarks to determine the parameters of a reasonable range of rates to then measure against the statutory factors. In re Determination of Rates and Terms for Preexisting Subscription Servs. & Satellite Digital Audio Radio Servs., *Final Determination of Rates and Terms*, 73 Fed Reg. 4080, 4084 (Jan. 24, 2008) (“SDARS Determination”).

3. In this proceeding, the Copyright Owners seek rates of 12.5 cents per song for physical phonorecords and 15 cents per track for permanent downloads, both subject to periodic CPI adjustments, employing the “Consumer Price Index-Urban Wage Earners and Clerical Workers” (U.S. Bureau of Labor Statistics Series CWSR0000SA0). The Copyright Owners propose a rate for ringtones equal to the greatest of: (i) 15 percent of revenue; (ii) one-third of total content costs; or (iii) a penny minimum of 15 cents per ringtone. As the weight of the evidence throughout both the direct and rebuttal phases of this proceeding established, the Copyright Owners’ rate proposal falls well within the range of reasonableness established by appropriate market benchmarks and is fully consistent with all of the Section 801(b) statutory factors.²

4. By contrast, the dramatic rate reductions proposed by the Recording Industry Association of America, Inc. (“RIAA”) and the Digital Media Association

² In addition, on May 15, 2008, the Copyright Owners and the Copyright Users notified the Court that they had entered into a partial settlement to set rates and terms for limited downloads and interactive streaming in this proceeding for the rate period at issue. Pursuant to the Court’s May 27, 2008 Order on the Joint Motion To Adopt Procedures For Submission of Partial Settlement, which granted the parties relief from the obligation to submit findings of fact on the settled issues, we focus on only companies in the physical phonorecord, permanent download, or ringtone business, and, to the extent necessary, provide basic background information concerning subscription services that offer permanent downloads.

(“DiMA”)—seeking cuts of 30 to 60% from the current rate—lack support in market benchmarks, economic theory and the facts.

The Songwriters

5. Songwriters are the composers and lyricists who write the musical compositions that form the foundation of the recorded music industry and the parties in whom the musical work copyright initially vests. Simply put, absent the creative input of songwriters, there would be no song for artists to sing and record, and no sound recording for record companies and digital music companies to distribute and sell to the public. 1/28/08 Tr. at 212-13 (Carnes).

6. Given the significance of their contribution to the creative process, songwriters are the parties who typically earn between 75% and 95% of mechanical royalties. Peer WDT (CO Trial Ex. 13) at 6-7. Thus, even though they received barely a mention by the RIAA and DiMA throughout this proceeding, songwriters represent the true economic interest at issue in this dispute.

7. Notwithstanding that songwriters receive the lion’s share of mechanical royalties, songwriting remains a financially risky profession even for songwriters who enjoy success. Throughout this proceeding, songwriters testified, in chorus, of the numerous struggles they face. Most work, or have worked, second jobs to make ends meet, leaving them little time to devote to a craft that requires long hours and peace of mind to perfect. Sharp WDT (CO Trial Ex. 6) at 6-7; Bogard WDT (CO Trial Ex. 2) at 8.

8. And no matter how hard songwriters work, they are beset by numerous risks. They never know if a song will be recorded. They never know if a recorded song will be released. And they never know if a released song will sell, and if so, how well.

And for those who score a hit, they never know when the next will come. *See, e.g.*, Galdston WDT (CO Trial Ex. 4) at 4-5; 1/30/08 Tr. at 790-91 (Galdston).

9. As the songwriter witnesses further recounted, songwriters depend heavily on mechanical royalty income for their livelihood—income that frequently is never seen by the songwriter until years after his or her investment. And even for hit songs, mechanical royalty income is low and, in the current climate, declining due to several factors. 1/28/08 Tr. at 201 (Carnes); Shaw WDT (CO Trial Ex. 5) at 4.

10. As numerous record company witnesses agreed, the piracy plaguing the recorded music industry has hit songwriters hard. *See, e.g.*, 2/20/08 Tr. at 3913 (Bassetti). So, too, has the pervasive use of “controlled composition clauses” by record companies in their recording contracts with singer-songwriters. These clauses reduce mechanical royalty income by 25% and cap the number of tracks on which mechanical royalties are paid, typically at 10. *See, e.g.*, CO Trial Ex. 56; CO Trial Ex. 297; 1/28/08 Tr. at 207 (Carnes). Moreover, these clauses affect not only the compensation of singer-songwriters but also compensation of the co-writers who collaborate with them. 5/14/08 Tr. 6412-15 (Faxon). And even though Section 115 prohibits record companies from applying controlled composition clauses to permanent downloads released pursuant to recording contracts post-dating June 22, 1995, at trial, one record company confessed nevertheless to applying a provision of the controlled composition clause, the effect of which is to reduce the units on which mechanical royalties are sold to 85%—thereby helping itself to the discount that Section 115 prohibits. *See* 5/12/08 Tr. at 5731-42 (A. Finkelstein).

11. Numerous songwriters testified to a decline in their mechanical royalties—testimony corroborated by the financial statements of the music publishers and The Harry Fox Agency, Inc. (“HFA”), NMPA’s licensing affiliate, through which the vast majority of mechanicals are paid. CO Trial Ex. 12A, 12 B; Santisi WRT (RIAA Trial Ex. 78) Table A; Faxon WRT (CO Trial Ex. 375) Exs. A, B. The decline in mechanical royalties was further confirmed by empirical work performed by the chief economist witness for the Copyright Owners, Professor William Landes. Landes WRT (CO Trial Ex. 406) at 8.

12. From a study of nearly 10,000 songwriters whose compositions were administered by Universal Music Publishing Group (“UMPG”), Professor Landes reached several conclusions concerning trends in songwriter income. Landes WRT (CO Trial Ex. 406) at 8. First, for the period 2000 to 2006, Professor Landes observed declines in both average and median annual mechanical income. Second, Professor Landes concluded that a reduction in mechanical income would likely reduce the total earnings of many songwriters. Finally, Professor Landes confirmed what several songwriters said was the case: songwriters depend heavily on mechanical royalties. *Id.* at 8-11. Even the RIAA’s economist in the direct phase of the proceeding, David Teece, agreed that mechanical royalty income is declining on both a nominal and real dollar basis. Teece WDT (RIAA Trial Ex. 64) at 59.

13. As a result of their significant contributions, substantial risk and dwindling mechanical income, among other factors, the songwriters were unanimous in their belief that they are not fairly compensated by the current mechanical royalty rate. *See, e.g.,* Shaw WDT (CO Trial Ex. 5) at 7; 1/30/08 Tr. at 834-45 (Shaw). They further testified

that an increase in the mechanical royalty rate would lead to an increase in the number of songwriters and musical compositions, while a decrease would have the opposite effect. *See, e.g.*, Bogard WDT (CO Trial Ex. 2) at 10; 1/28/08 Tr. at 222 (Carnes); 1/30/08 Tr. at 801-02 (Galdston). It would hasten the exit of the many professional songwriters already leaving their careers behind and build even greater obstacles before the aspiring songwriters who may well be the creators of the next great American song. 1/30/08 Tr. at 801-02 (Galdston).

The Music Publishers

14. While the songwriters were simply ignored by the RIAA and DiMA, the music publishers were dismissed as mere passive recipients of royalties. *See, e.g.*, Kushner WDT (RIAA Trial Ex. 62) at 2. But as abundant evidence in this proceeding established, music publishers are anything but. They play vital roles in contributing to the music industry and making creative works available to the public. *See, e.g.*, Faxon WDT (CO Trial Ex. 3) at 4-12; Robinson WDT (CO Trial Ex. 8) at 10-21; 1/31/08 Tr. at 950-55 (Robinson).

15. First, as each publisher witness testified, music publishers discover and nurture songwriting talent from the earliest stages of their careers through significant investments in, and great efforts made by, their Artist & Repertoire (“A&R”) departments. *See, e.g.*, 2/15/08 Tr. at 1578-79 (Peer). Indeed, publishers are credited with having discovered talent such as James Blunt long before the record companies and to standing by artists and songwriters such as Buddy Holly and Linda Perry after their labels dropped them, leading to great musical successes that ultimately benefited the record companies. Robinson WDT (CO Trial Ex. 8) at 17; 2/5/08 Tr. at 1589-93 (Peer); 1/29/08 Tr. at 380-82 (Faxon).

16. The publishers also highlighted the critical financial support they provide to songwriters in the form of advances and other payments—financial provisions that allow songwriters to focus on their craft and that come at great costs and risk to the publishers. Firth WDT (CO Trial Ex. 24) at 9-12; 1/31/08 Tr. at 964-65 (Robinson). As the publishers explained, although advances are recoupable against songwriters’ future earnings, the success rate for even the most successful songwriters is far from a good bet—somewhere between 2% and 10%—leading to approximately half advances never being recouped. 2/12/08 Tr. at 2666 (Firth); Robinson WDT (CO Trial Ex. 8 at 19; 1/31/08 Tr. at 967 (Robinson).

17. Music publishers further testified to the significant creative support they provide to songwriters, including providing constructive criticism on songs and editing them. *See, e.g.*, Robinson WDT (CO Trial Ex. 8) at 19. Even more important, music publishers arrange for collaborations among songwriters and recording artists that help lead to successful recordings. *See, e.g.*, 1/31/08 Tr. at 874 (Sharp).

18. The role of the publisher does not end with the conclusion of the creative process. One of the primary roles played by the publisher is that of promoter or “song plugger.” Peer WDT (CO Trial Ex. 13) at 11-12; 1/30/08 Tr. at 820-21 (Shaw). To that end, music publishers pitch songs to record companies to get them recorded, and seek out licensing opportunities beyond releases on new albums, such as synchronization opportunities in film and television. Faxon WDT (CO Trial Ex. 3) at 10; 1/31/08 Tr. at 952 (Robinson). Finally, music publishers play important administrative roles on behalf of songwriters—from handling licensing and royalty collection, to performing royalty

audits and representing the interests of songwriters in a variety of legal matters to protect their creative and financial interests. Firth WDT (CO Trial Ex. 24) at 17-20.

19. Even though music publishers receive typically only a 25% share of mechanical royalties, mechanical royalties nevertheless are a significant source of income on which publishers heavily depend. As Professor Landes found, mechanical royalties represent between 30-65% of total publisher royalties for six publishers. Landes WDT (CO Trial Ex. 22) at 15. And like the songwriters, the music publishers are experiencing declines in their mechanical royalty income for the reasons noted above, as the evidence presented by RIAA rebuttal expert Terri Santisi confirmed. Santisi WRT (RIAA Trial Ex. 78) at 49; 5/7/08 Tr. at 5214, 5222-23 (Santisi).

20. The publishers identified several reasons supporting an increase in the mechanical royalty rate. Among others, the publishers emphasized the industry changes following the parties' negotiated settlement in 1997—specifically, the decline in physical product sales and the growth in the digital market. *See, e.g.*, 1/31/08 Tr. at 929-32 (Robinson). As many witnesses throughout the proceeding explained, the growth in the digital market and, in particular, the popularity of the permanent download, has led to the transformation of the market from an albums-based to a singles-based format, which has further depressed the level of mechanical license fees, and to increased value to the consumer. *See, e.g.*, 1/29/08 Tr. at 429-430 (Faxon); Enders WDT (CO Trial Ex. 10) at 6-7.

The Recorded Music Industry

21. The recorded music market of today stands in stark contrast to the market that served as the backdrop to the current statutory rate, having undergone a fundamental transformation over the past decade.

22. The past decade is not the first time the recorded music industry has undergone such change. As the evidence established, over the past four decades, the recorded music industry experienced two periods of rapid growth followed by brief declines. H. Murphy WDT (CO Trial Ex. 15) at 4; 2/6/08 Tr. at 1763-64 (H. Murphy). Each phase of growth was driven by technological change. The first period saw the market penetration of the cassette followed by a period of contraction due to piracy and economic recession. H. Murphy WDT (CO Trial Ex. 15) at 9. The second period of growth resulted from the market penetration of the Compact Disc (the “CD”), which lasted from the mid-1980s through the mid-1990s, as sales of CDs and the growth and profits of the record companies soared. *Id.* at 4-9.

23. In the mid-1990s, change took hold again—this time in the form of the distribution of music over the Internet in MP3 file format. The major record companies did not embrace digital distribution, which helped illegal file-sharing sites such as Napster caused online piracy to flourish. *Id.* at 13. The piracy problem, although somewhat contained, continues to plague the industry today. Enders WDT (CO Trial Ex. 10) at 10-11.

The Development of the Digital Music Market

24. In 2001, at least two years too late, the record companies finally launched their own legitimate digital music services. Enders WDT (CO Trial Ex. 10) at 11; 2/4/08 Tr. at 1156-57 (Enders). But these services failed consumers in two important respects. First, they did not offer consumers catalog from all the majors. Second, they proposed a radically different business model than that to which consumers were accustomed: a subscription-based service that offered only temporary, rather than permanent, ownership

of music. *See* 2/4/08 Tr. at 1166-67 (Enders). Consumers swiftly rejected the sites, as piracy became even more pervasive. Enders WDT (CO Trial Ex. 10) at 10-11.

25. In 2003, Apple—having successfully convinced (against great resistance) all of the major record companies to grant it licenses—finally launched the answer: its iTunes Music Store and the permanent download model of music distribution. 2/25/08 Tr. at 4222, 4320 (Cue). Under the terms of its licenses with the majors, Apple typically pays them [REDACTED]. *See, e.g.*, CO Trial Exs. 90-93. Apple [REDACTED]. 2/25/08 Tr. at 4329 (Cue).

26. Apple set the initial retail price of its permanent downloads at 99 cents and has not changed it since. Despite Apple's claims that it cannot raise its price and still compete with pirated music, both Apple and DiMA's economist witness, Margaret Guerin-Calvert, confessed to having never done any empirical work—let alone a price sensitivity analysis—to support these claims. *Id.* at 4266-68; 4332-35; 2/26/08 Tr. at 4581-84 (Guerin-Calvert).

27. The iTunes store was an immediate hit and its success continues today, with Apple offering a catalog of over 6 million songs, selling over 25 million songs per week in the first half of 2007, and claiming an 85% share of the permanent download market. 2/25/08 Tr. at 4236, 4246 (Cue); Enders WDT (CO Trial Ex. 10) at 14-15, 28. Apple's business model is founded on its sale of iPods, on which it derives an over 20% profit margin and the only device on which music purchased through iTunes can be played (other than the limited DRM-free catalog offered by Apple since 2007). Apple has not kept its model for success a secret, publicly proclaiming that its goal was to run

the iTunes store just above break-even and drive the sale of iPods through the sale of iTunes music. In fact, Apple's iTunes Store is thriving, [REDACTED]

28. Notwithstanding continued online piracy and Apple's dominance of the permanent download market, numerous other retailers have entered the permanent download market, including Wal-Mart, Best Buy, Amazon and Microsoft, as well as certain of the subscription services, each of which has benefited from the consumer preference for the permanent download. Consumers are clear about why they choose to pay for permanent downloads sold by Apple and others, citing among other reasons the ability to cherry-pick a single track and increased value, such as convenience and portability. Enders WDT (CO Trial Ex. 10) at 20-21.

29. Mobile music is distributed primarily in two forms—the ringtone, and the over-the-air full track download. Introduced in the early to mid-1990s, ringtones first took the form of so-called monophonic and polyphonic ringtones and shifted to mastertones, which are ringtones derived from sound recordings, in approximately 2005. As numerous music publishers testified, they and songwriters played a critical role in the development of this market through the widespread licensing of their works as ringtones. Robinson WDT (CO Trial Ex. 8) at 12; 1/29/08 Tr. at 435-44 (Faxon). Today, mastertones are priced by the major wireless carriers at around \$2.00 to \$2.50. Enders WDT (CO Trial Ex. 10) at 42. Wireless carriers also offer consumers full track downloads, mostly in the form of “dual-downloading,” which allows consumers to download tracks to both their cellular phones and personal computers. Dual downloads range in price from \$1.99 to \$2.50. *Id.* at 43.

The Reorientation of the Record Companies

30. As the lawful digital market was developing, the record companies were reorienting and restructuring. Beginning in 2001, the record companies began significant restructuring programs to shed their excess expenses, including through selling their manufacturing plants dedicated to physical product sales on the wane, setting the stage for their current healthy financial state. 1/30/08 Tr. at 557-63 (Faxon); Teece WDT (RIAA Trial Ex. 64) at 88.

31. Today, although CD sales continue to decline, the U.S. digital market is thriving, with total digital music sales (online and mobile) dramatically on the rise. In 2007, total U.S. digital music sales reached approximately \$2.7 billion and grew to approximately 30% of total U.S. recorded music sales. Enders WDT (CO Trial Ex. 10) at 22; 2/4/08 Tr. at 1246-47 (Enders).

32. Although the record companies have painted a picture of gloom concerning their financial condition, the record evidence reveals that the vibrant digital market has, in fact, led to lower costs and growing profits for the record companies, notwithstanding their recent declines in total revenue. *See* H. Murphy WDT (CO Trial Ex. 15) at 23.

33. Most significantly, the transformation to the digital market has essentially eliminated the record companies' costs of manufacturing and distribution. Unlike the physical world in which record companies incur the costs of manufacturing CDs, artwork for CD packaging and jewel cases, as well as physical distribution costs including significant return costs, the digital world comes with no such costs. Several record company executives conceded as much—admissions confirmed by record company profit and loss statements created in the ordinary course of business. *See, e.g.*, 2/13/08 Tr. at

3175, 3269 (C. Finkelstein); CO Trial Ex. 19. The purportedly contrary testimony of RIAA witness Bruce Benson flies in the face of a white paper—reviewed and revised by Mr. Benson himself— released by his consulting firm only months before the trial that acknowledged that “manufacturing, distribution and return costs . . . do not exist for digital sales.” CO Trial Ex. 262.

34. Although the record companies have contended throughout this proceeding that they require the reduction of mechanical royalties to survive, again, the record evidence is to the contrary. Much of the costs over which the record companies have control, including the costs paid by the record companies for the only other creative input, artist royalties, continue to rise as a percentage of record companies’ net revenues. Between 1999 and 2006, mechanical royalties were approximately 50% lower than artist royalties, never accounting for more than 11% of record companies’ total costs. Benson WRT (RIAA Trial Ex. 82) at 8 (Figure 1).

The Record Companies’ Record Profits

35. As a result of the vibrant growth of the digital market and the corresponding dramatic reduction in manufacturing and distribution costs, record companies have been enjoying record profits in recent years, according to evidence presented by Mr. Benson and economist Linda McLaughlin, both witnesses for the RIAA, and Helen Murphy, a witness for the Copyright Owners. This evidence—all derived from the record companies’ internal financial documents—tells a story far different from the record companies’ tales of woe.

36. Consider the profitability of each of the major record companies. Warner’s OIBDA margin [REDACTED]—consistent with its public statements that it enjoys “an operating margin advantage in digital.” H.

Murphy WDT (CO Trial Ex. 15) at 18; CO Trial Ex. 21. Universal Music Group's EBITDA margin [REDACTED]. *Id.* Sony's pretax profit [REDACTED]. *Id.* And although EMI's results have been uneven, its own executives identified the causes: mismanagement, excessive spending on artists, high return costs and a dramatic drop in market share. See 2/26/08 Tr. at 4749-51 (Munns); 2/14/08 Tr. at 3299-301 (C. Finkelstein).

37. Faced with a heap of evidence of their profits, the record companies tried on rebuttal to recast their financials through Mr. Benson. But as Mr. Benson ultimately admitted, he could not explain why he had been provided with \$1 billion in purportedly additional expenses not taken into account by Ms. McLaughlin who had sworn to the accuracy of her numbers just months before. 5/8/08 Tr. at 5528 (Benson). In any event, even Mr. Benson's results demonstrate the record companies' return to profitability. Benson WRT (RIAA Trial Ex. 82) at 8 (Figure 1).

The Success of Apple

38. For the online music providers, as well, the digital world has brought lower costs and rising profitability. The permanent download market, in particular, has enjoyed sustained and substantial growth, reaching \$878 million in 2006. Enders WDT (CO Trial Ex. 10) at 23 n.46. Apple alone sold nearly a billion dollars of permanent downloads in 2007 and is projecting sales in excess of [REDACTED] for 2008. 2/25/08 Tr. at 4294-95, 4298 (Cue). For permanent download providers, the most significant cost is that of content licensing, with the costs for the sound recording dramatically higher than those for the musical composition. 2/25/08 Tr. at 4258 (Cue).

39. Even with its costs, iTunes has been a financial success for Apple from the start. Leaving to one side Apple's profit margins from the sale of iPods driven by its sale

of iTunes music, the sale of digital music through iTunes [REDACTED]
[REDACTED]. So much so that, as one of the Copyright
Owners' experts, Claire Enders, analyzed, if Apple were to absorb the Copyright
Owners' proposed increase—contrary to its current licensing scheme under which the
record companies pay mechanicals—it still would enjoy a healthy contribution margin.
Enders WDT (CO Trial Ex. 10) at 51.

***The Bright Futures of the Record Companies
and Permanent Download Providers***

40. By all accounts, the futures of the record companies and the online
providers of permanent downloads are bright. Numerous public forecasts for the
recorded music industry project the digital market to grow rapidly over the rate period.
According to Ms. Enders, digital sales are expected to rise to \$5 billion by 2012. Enders
WDT (CO Trial Ex. 10) at 22, Ex. C. Other forecasts are consistent with or even rosier
than are Ms. Enders'. *Id.* at 57-58.

***The Copyright Owners' Proposal
and Supporting Benchmarks***

41. In view of the evidence of great and prosperous change in the industry,
their significant contributions and risk, and their declining mechanical royalties, the
Copyright Owners have proposed increases to the mechanical royalty rates, as detailed
above.

42. In support, Professor Landes identified two principal benchmarks rooted
in competitive markets uninfluenced by the Section 115 statutory rate—the mastertone
market and the synchronization market—in which copyright users acquire the rights to
both the sound recording and underlying musical composition. Landes WDT (CO Trial
Ex. 22) at 23-25; Landes WRT (CO Trial Ex. 406) at 28-29.

43. With respect to the mastertone market, Professor Landes conducted a comprehensive review of voluntary marketplace mastertone licenses, including licenses granted by music publishers directly to third party sellers of ringtones and licenses granted directly to the record companies, both in the form of stand-alone licenses, which covered solely mastertone rights, and the so-called “New Digital Media Agreements,” which covered mastertone rights and rights for other products. Based on his review, Professor Landes found that the Copyright Owners typically receive 20% of the total amount paid for musical compositions and sound recordings in the mastertone market.

44. The record companies’ efforts to undermine the mastertone market all missed the mark. Contrary to their argument that the mastertone market was too small to serve as a benchmark, the evidence established that the market, in fact, is significant in terms of the number of songs earning licensing revenue and in terms of the total mastertone revenue earned by the record companies—constituting, according to the RIAA’s rebuttal economist, Steven Wildman, the record companies’ third largest source of revenue. 5/12/08 Tr. at 5966 (Wildman).

45. Having conceded the significance of the mastertone market to the record companies, Professor Wildman, along with another RIAA rebuttal economist Daniel Slottje, hurled a number of baseless economic criticisms at Professor Landes’ mastertone benchmark. *See, e.g.*, Slottje WRT (RIAA Trial Ex. 81) at 21; Wildman WRT (RIAA Trial Ex. 87) at 17-18. But their assertion that the demand and supply characteristics of the mastertone market differ from that of the recorded music market has no support in the record. Nor does Professor Wildman’s “bargaining theory” (a subject on which he

conceded he has no expertise) find any support in the facts. *See* 5/12/08 Tr. at 5935-47 (Wildman).

46. Equally unavailing was Professor Wildman's claim that somehow the preexisting market in monophonic and polyphonic ringtones—a market in which the publishers received payments consistent with those in the mastertone market—allowed publishers to exert increased bargaining leverage in the negotiation of the NDMA's. *See* Wildman WRT (RIAA Trial Ex. 87) at 29. Again, Professor Wildman conceded the flaws in his argument. First, he admitted that such a finding would hinge on a complete, complex analysis of, among other considerations, the cross-elasticity of demand of the two products—an analysis Professor Wildman never performed. Wildman WRT (CO Trial Ex. 87) at 20. Second, Professor Wildman acknowledged that it was entirely possible that publishers would have accepted lower rates for mastertones than they had for monophonic and polyphonic ringtones—flatly contradicting his contention that publishers would have “demanded a higher price.” *See, e.g.,* 5/12/08 Tr. at 5970-72 (Wildman).

47. As for the RIAA's assertion that the mastertone rates in the NDMA's were the product of trade-offs on other rights, it, too, suffers from a lack of factual support. As an initial, but dispositive, matter, the NDMA mastertone rates are entirely consistent with standalone mastertone licensing activity pre- and post-dating the NDMA's. And the “other right” on which the record companies claim their concessions on the mastertones were based—the “DualDisc”—hardly supports the argument. The NDMA's were not, as the RIAA contended, necessary to launch the DualDisc market, because its launch predated the NDMA's. 2/20/08 Tr. at 3977 (Wilcox). Further, several record company

executives testified that the DualDisc, far from a lifeline for the physical market, was, in fact, a failure from the start. *Id.* at 3980-81. In any event, revenues for Sony BMG, for example, generated from the sales of DualDisc—[REDACTED]—pale in comparison to the mastertone revenue over the same period, [REDACTED]. CO Trial Ex. 77 at 1-2. And perhaps most telling, two record companies extended their NDMAAs with EMI Music Publishing (“EMI MP”) in 2007, after the DualDisc’s commercial death, [REDACTED]. [REDACTED]. CO Trial Ex. 375, Ex. C; Faxon WRT (CO Trial Ex. 375) at 6-7; 5/14/08 Tr. at 6372-75, 6383-6386 (Faxon).

48. Finally, there is no support for the claim by the RIAA that the mastertone agreements should not be credited because the parties viewed the market as “fleeting” and soon to be “obsolete.” The parties’ actions speak to the contrary, as do the forecasts of Ms. Enders and others that the U.S. ringtone market will reach nearly \$1.5 billion in 2012. Enders WDT (CO Trial Ex. 10), Ex. C at 6.

49. Regarding the synchronization market, Professor Landes again analyzed the competitive transactions in the marketplace. As those transactions revealed, through the use of “most favored nations” clauses in synchronization licenses granting rights to musical compositions on the one hand, and master use licenses granting rights to sound recordings, on the other, copyright owners of musical compositions and copyright owners of sound recordings typically receive equivalent licensing fees. Thus, the publishers and the record companies each receive 50% of the content pool. 2/7/08 Tr. at 2084-87 (Landes).

50. Like the RIAA’s arguments against the mastertone benchmark, the RIAA’s arguments to undermine Professor Landes’ synchronization benchmark have no

merit. Again, Professor Wildman’s bargaining theory lacked any empirical work. 5/12/08 Tr. at 5936 (Wildman). It also contradicted testimony by record company executives that the record companies’ primary goal in negotiating master use licenses was to maximize revenue. 5/7/08 Tr. at 5277 (Pascucci). It also ignores evidence of a symmetry of competitive pressures on both sides of the transactions with respect to alternatives for use of the recording and the song. *Id.* at 5293-95; Landes WRT (CO Trial Ex. 406) at 31-32; 2/11/08 Tr. at 2457-58 (Landes).

51. Professor Landes further relied on the Audio Home Recording Act (the “AHRA”), which divides royalties from the sale of certain digital recording devices between the owners of musical compositions and sound recordings. Landes WDT (CO Trial Ex. 22) at 24. Thus, Professor Landes found that the division in the AHRA—reflecting the compromise of competing interests in the legislative context—was one-third for the musical works fund and two-thirds for the sound recording fund. *Id.*

52. Based on his analysis of the mastertone and synchronization benchmarks, and the corroboration of the AHRA, Professor Landes derived a “range of reasonableness” within which royalties for the Copyright Owner should fall: 20% to 50% of the total license fees paid for the musical composition and the sound recording. Landes WDT (CO Trial Ex. 22) at 23. Professor Landes further concluded that the Copyright Owners’ proposed rates fell well within—indeed, at the low end of—his range of reasonableness. Specifically, Professor Landes determined that the Copyright Owners’ proposal for physical phonorecords would result in payments in the range of 18% of the content pool (taking into account effective rates as a result of below-statutory rate negotiations); payments in the range of 21% for permanent downloads, and payments in

the range of one-third of the content pool for ringtones. 2/7/08 Tr. at 2178-79 (Landes); Landes WDT (CO Trial Ex. 22) at 33-34.

53. In supporting the Copyright Owners' proposed rates, Professor Landes emphasized several important factors for the Court's consideration. As both Copyright Owner and RIAA witnesses, including economists testifying on behalf of each party, explained, the statutory rate acts as an effective "ceiling" on the mechanical royalty rate. Landes WRT (CO Trial Ex. 406) at 39; 5/12/08 Tr. at 5900 (Wildman). Copyright Owner rebuttal economist Kevin Murphy explained, for example, that the effect of the statutory license is to allow bargaining below, but not above, the statutory rate. And indeed, as the record also revealed, the parties, in fact, negotiate below the statutory rate both in the context of controlled composition clauses and otherwise, resulting in noticeable discounting facilitated by the absence of significant transaction costs in connection with such negotiations. *See, e.g.*, Landes WDT (CO Trial Ex. 22) at 12-15.

54. Finally, both Professor Landes and Professor Murphy warned of the danger of setting the mechanical royalty rate too low. Simply put, a rate that is too low will discourage the creation of musical works, thereby reducing the number of musical compositions and reducing the quality of musical compositions. Landes WRT (CO Trial Ex. 406) at 2; 5/19/08 Tr. at 6983 (K. Murphy).

The Significance of the Penny Rate

55. In addition to establishing that their rate proposals are supported by market benchmarks and at the low end of a range of reasonableness, the Copyright Owners also demonstrated that the penny rate, in place for almost 100 years, is working well and should be continued for CDs and permanent downloads, for several reasons.

56. First and foremost, a penny rate is a usage-based metric that preserves the intrinsic value of musical compositions, no matter how they are distributed by record companies and digital music services. 2/7/08 Tr. at 2173 (Landes); 1/29/08 Tr. at 480 (Faxon). And the penny rate is simple to apply, requiring consideration of only two factors: the rate itself and units distributed. 2/7/08 Tr. at 2173 (Landes).

57. By ensuring compensation on a usage basis, the penny rate provides important protections to the Copyright Owners that the percentage of revenue rates proposed by the RIAA (without any minima) and DiMA (with insufficient minima) omit. Tellingly, the record companies hardly deprive themselves of a penny or dollar payment (or at least, a fixed minimum fee) in their contractual arrangements for the very same reasons that the Copyright Owners seek such a rate here: to preserve the value of their creative input in the event a retailer seeks to sell music at a discount in an effort to generate advertising revenue or fuel sales of other products. *See, e.g.*, CO Trial Ex. 92 at DiMA 3781; CO Trial Ex. 112 at DiMA 10724-10725; 5/13/08 Tr. at 6112 (Eisenberg).

58. The record evidence reveals the significance of such protections and the reasons why the Copyright Owners should not simply trust that a percentage rate will fairly compensate them. Although the record companies claim that their economic incentives overlap with what is best for the Copyright Owners, the parties' interests are far from aligned. As economic theory predicts and market evidence confirms, the record companies' motive is to maximize profits, not revenues, from the sale of music. Teece WDT (RIAA Trial Ex. 64) at 71 fn.79; Landes WRT (CO Trial Ex. 406) at 22.

59. Moreover, abundant testimony made clear how each of the revenue definitions proposed by the RIAA and DiMA are subject to manipulation that could leave

the Copyright Owners potentially penniless, even as their works are widely distributed. For example, both the RIAA and DiMA propose to cut mechanical royalties when music is sold in “bundles” with other products. *See, e.g.*, 5/12/08 Tr. at 5667 (A. Finkelstein); 5/6/08 Tr. at 4918 (Guerin-Calvert). Even though record companies have begun to exchange music for equity stakes in Internet companies—the recent deal between Sony BMG and MySpace is a key example—under the RIAA’s proposal, the Copyright Owners would not share in such stock-based compensation. 5/12/08 Tr. at 5716-19 (A. Finkelstein). Further, the RIAA and DiMA revenue definitions are both so ambiguous that their witnesses gave conflicting testimony on how the definitions would apply, or simply admitted that they did not know how the proposals worked, further highlighting the danger associated with adopting a percentage of revenue model. *See, e.g.*, 5/6/08 Tr. at 4856-64 (Guerin-Calvert); 5/13/08 Tr. at 6133-37 (Eisenberg).

60. In contrast to the compelling evidence of risk to the Copyright Owners from a percentage rate, not a stitch of competent evidence supports the arguments advanced by the RIAA and DiMA in support. The penny rate has not impeded the dramatic growth of the digital music industry or prevented new entrants into the permanent download market. And companies like Amazon and Wal-Mart have jumped into the market and *undercut* the 99-cent iTunes retail price, all the while paying a penny rate on 9.1 cents. 5/6/08 Tr. at 4832 (Guerin-Calvert).

61. Nor has the growth or innovation of the record companies been impeded by the penny rate. Rather, the record companies have rolled out a vast array of new products (both physical and digital), new business models and new marketing strategies. *See, e.g.*, Wilcox WDT (RIAA Trial Ex. 70) at 2. For example, both Sony BMG and

Universal Music Group have recently entered into agreements with Nokia for a service called “Comes With Music,” which gives purchasers of Nokia cell phones unlimited permanent downloads to both their phones and their permanent computers. 5/14/08 Tr. at 6042, 6052-53 (Eisenberg). Perhaps most telling, in late 2007—while contending to this Court that they could not survive, much less thrive, in a penny rate regime, the record companies entered into an agreement to continue (and increase) the penny rate for mechanical royalties on physical product in Canada. Significantly, the growth in digital distribution in the United States has far outstripped all of the countries that calculate mechanical revenues on a percentage of revenue basis. Fabinyi WDT (CO Trial Ex. 380) at 11; 2/13/08 Tr. at 3204-06 (C. Finkelstein).

62. The RIAA’s arguments that the percentage rate would alleviate certain alleged licensing administration problems had no greater evidentiary support. Indeed, the RIAA’s key witness on administration issues admitted that the percentage rate would, in fact, make no difference to mitigating her complaints. 2/14/08 Tr. at 3389-90 (A. Finkelstein). The evidence shows that the penny rate is easier to administer than a percentage rate, which requires consideration of a third variable: price. 2/7/08 Tr. at 2173 (Landes).

63. Finally, the Copyright Owners’ proposal for ringtone rates largely follows the structure of historical and current marketplace agreements and thus should be no more difficult to administer. *See, e.g.*, Landes WDT (CO Trial Ex. 22) at 40. The Copyright Owners and the RIAA agree that the rate should be calculated at least in part on a percentage basis, but the RIAA seeks to deny the Copyright Owners their requested 15-cent minimum, even though the record companies have typically demanded \$1.00

minima in their agreements with third-party ringtone providers. *Id.* at 46. Nothing in the record suggests that the Copyright Owners do not deserve the same downward pricing protections as those enjoyed by the record companies.

The Copyright Users' Proposals

64. Notwithstanding the mountain of evidence supporting the increase in the mechanical royalty rates proposed by the Copyright Owners and the continuation of the penny rate, the RIAA and DiMA have proposed draconian reductions to the already low, and declining, mechanical royalty income paid to songwriters and music publishers.

***The RIAA's Proposed Rates
Are Unsupported by Benchmarks or Facts***

65. During the direct phase of this proceeding, the RIAA proposed a percentage rate for all products of 7.8% of wholesale revenue, which it purported to support through its economist, Professor Teece. Following the direct hearing, in which the Copyright Owners exposed the fundamental flaws in Professor Teece's analysis, the RIAA returned to the rebuttal phase with a changed economist and a changed proposal. But the RIAA's amended proposal—seeking 9% of wholesale revenue for all physical product and permanent downloads and 15% of wholesale revenue for ringtones—is no more defensible than its first proposal. In the Matter of Mechanical and Digital Phonorecord Delivery Rate Adjustment Proceeding, *Amended Proposed Rates and Terms of Recording Industry Association of America, Inc.*, Docket No. 2006-3 CRB DPRA (April 10, 2003), at 12 (“RIAA Amended Proposal”).

66. In support of the RIAA's direct proposal, Professor Teece offered the determination made by the Copyright Royalty Tribunal (“CRT”) in 1981 as his primary benchmark from which he purported to derive the RIAA's proposed 7.8% of wholesale

revenue rate (notwithstanding that the decision itself set a penny rate). *See Adjustment of Royalty Payable Under Compulsory License for Making and Distributing Phonorecords, Rates and Adjustments of Rates*, 46 Fed. Reg. 10466 (Feb. 3, 1981) (the “1981 CRT Decision”). But Professor Teece’s 1981 Decision benchmark—nearly three decades old—has no applicability to the current recorded music market, which is starkly different from that at the time of the 1980 proceeding. Professor Teece so conceded, likening the evolution of the market from that time to a “transformational change.” 2/19/08 Tr. at 3640 (Teece).

67. Moreover, Professor Teece’s methodology used to “derive” a rate from the 1981 Decision was empirically baseless. Professor Teece’s calculation hinged on his erroneous assumption that the retail list price of albums at the time was the “functional equivalent” of the average actual price, when the evidence before the CRT—which Professor Teece confessed to never considering—was, in fact, to the contrary. Teece WDT (RIAA Trial Ex. 64) at 80; 2/19/08 Tr. at 3681-82 (Teece). Further, Professor Teece’s opinion that the 7.8% rate was appropriate without consideration of the applicable revenue bases, to use his own words, “ma[d]e[] no sense.” 2/19/08 Tr. at 3700 (Teece).

68. With its principal direct benchmark doomed, the RIAA, through Professor Wildman, offered two new benchmarks on rebuttal: (1) the effective mechanical royalty rate; and (2) the license rates for first uses of musical compositions. But both suffer the fundamental flaw of not being independent market rates, and neither is supported by the record.

69. In support of his effective rate benchmark, Professor Wildman relies on mechanical licenses issued below the statutory rate, which he admits are frequently a result of controlled composition clauses, claiming somehow that such rates are, in fact, the market rates. But as Professor Murphy explained and Professor Wildman ultimately conceded, those rates are far from market rates because they are derivative—not independent—of the statutory rate. K. Murphy WRT (CO Trial Ex. 400) at 14-17.

70. Effective rates resulting principally from controlled composition clauses are inappropriate as benchmarks for several more reasons. First, controlled composition clauses are just one element of recording agreements that involve many trade-offs on a variety of rights—a fact as to which all economists on both sides concurred. Second, Professor Murphy’s empirical study of controlled composition rates based on numerous artist contracts spanning five decades proved that those clauses are derivative of the statutory rate, by showing that controlled composition clause rates have remained relatively fixed, rather than—as would have been expected with a market rate—adjusting downward as the statutory rate rose. K. Murphy WRT (CO Trial Ex. 400) at 14-17. As an RIAA witness best put it, her company’s controlled composition clause in the future will just be “pegged to the new statutory rate.” 5/12/08 Tr. at 5744 (A. Finkelstein).

71. Professor Wildman’s first use benchmark—allegedly appropriate because first uses of musical compositions are not subject to the statutory license—fared no better. Professor Wildman again conceded that his first use benchmark is derivative rather than independent of the statutory rate since first use songs compete with and can be substituted by songs available through the mechanical license, as Professor Landes had concluded in rejecting just such a benchmark. 5/12/08 Tr. at 5826-57, 5894 (Wildman);

Landes WRT (CO Trial Ex. 406) at 40. Moreover, first use license rates are frequently set by controlled composition clauses and often serve as the ticket songwriters use to gain entry into the marketplace with the goal of generating future earnings. Finally, Professor Wildman's analysis of only limited data for limited time periods and without consideration of any analysis of median, as opposed to just mean, values is empirically deficient. And as for Professor Wildman's purported finding in his written testimony that the RIAA proposal was reasonable, he, like Professor Teece, performed no percentage of revenue calculations, and ultimately opined that rates higher than those proposed by the RIAA would be reasonable as well. 5/12/08 Tr. at 5888 (Wildman).

72. In addition to its flawed benchmarks, the RIAA offered evidence of international rates cherry-picked from the U.K. and Japan—absent any market comparability analysis whatsoever—which proved no more persuasive. (Indeed, Professor Wildman conceded that he could not support those rates as benchmarks.) As the Copyright Owners showed, there exist numerous differences in mechanical licensing in those two markets, making use of U.K. and Japanese rates as benchmarks inapposite. Notably, controlled composition clauses have no enforced counterpart in the U.K., the U.K. has no compulsory license; and the calculation of “wholesale” revenue differs from the calculation of published price to dealer (“PPD”), which is the revenue base used in the U.K, among other differences. Fabinyi WRT (CO Trial Ex. 380) at 4-9. And, as the Copyright Owners showed during the rebuttal hearing, a complete analysis of the landscape of international rates shows that U.S. rates, far from being the highest in the world as the RIAA has contended, fall well in line with worldwide rates, and in fact behind most European rates on a currency adjusted basis. *Id.* at Exs. F-1, F-2.

73. The other arguments put forward by the RIAA in support of its proposal are just as easily debunked by the evidence.

74. First, although the RIAA suggests that a decline in CD prices should result in a reduction in the mechanical royalty rate, economic theory and the empirical evidence counsel otherwise. As Professor Murphy observed, under conditions of falling prices for recorded music, economic theory predicts that songwriters will receive an increasing proportion of revenue relative to other record company inputs, due to the greater supply of alternative distribution methods, including the growth in the digital distribution of music. K. Murphy WRT (CO Trial Ex. 400) at 4-8. As Professor Murphy further explained, demand reduction in an environment of falling prices will require a relative increase in songwriter compensation to maintain the supply of songs. *Id.* at 8. To support his theory, Professor Murphy conducted a historical analysis of record company costs over a 15-year period, looking in particular at whether the record companies' costs for its other creative input—artist royalties—rose or fell with declining CD prices. Professor Murphy found what he predicted: declining CD prices and sales did not depress artist royalties. Finally, Professor Murphy's empirical work rebuts the RIAA's claims that mechanical royalties are out of line with historical proportions; in fact, mechanical royalties have accounted for a relatively constant percentage of total record company costs for artistic inputs.

75. Second, notwithstanding the record companies' claims that they are in dire financial condition and thus require a drastic rate cut, again the quantitative evidence is to the contrary. As discussed above, although the record companies' top-line revenues have declined, their profitability is at record levels, and rising, as a result of their seriously

diminished costs and improved margins in the digital world. *See* H. Murphy WDT (CO Trial Ex. 15) at 23.

76. Third, even though the record companies have attempted to dilute their record profits by claiming “significant” and “substantial” investments on digital infrastructure, witness after witness proved unable to quantify those costs to any degree. For good reason: the empirical evidence shows the contrary. In fact, the transition to the digital world, which brought the record companies lower costs and increased profits, came at minimal cost to them.

77. Fourth, recognizing the potential impact of the drastic rate reduction it seeks, the RIAA argued that its savings would be invested in new recording artists and releases and would ultimately benefit the Copyright Owners. As one of the RIAA rebuttal experts, Terri Santisi, conceded, she could offer no evidence in support of the RIAA’s claim or any evidence to support a correlation between mechanical payments and A&R spending whatsoever. 5/7/08 Tr. at 5179-83, 5253 (Santisi).

78. Finally, each and every one of the RIAA’s claims about songwriters and music publishers is contradicted by the record evidence. Although the RIAA argues that music publishers should not feel the sting of a radical rate reduction as a result of their other income streams, the RIAA entirely ignores that songwriters—most of whom do not share in significant other streams of revenue—receive the majority of mechanical income. Moreover, the evidence establishes that songwriters and music publishers make great contributions to the creation of recorded music, take significant risks, and have participated in the fight against piracy at nearly every step—refuting each and every one of the RIAA’s claims to the contrary. Finally, Professor Slottje argued that a reduction in

mechanical income allegedly will have little impact on creative contributions of songwriters, relying on theories that songwriters like their jobs and are compensated by a tournament-type pay structure. These arguments have no basis in economic theory or the testimony of the songwriters themselves, which shows that their creative endeavors are difficult and labor-intensive and cannot be sustained without fair compensation.

DiMA's Proposal Lacks Benchmark and Factual Support

79. DiMA's arguments fare no better. In the direct round of this proceeding, DiMA proposed a drastic reduction in mechanical royalty compensation to 4.1% of "applicable receipts" with no minima—in other words, a reduction of over 50%. Like the RIAA, on rebuttal DiMA returned with an increased amended proposal. Specifically, DiMA requested a rate of 6% of applicable receipts, which still seeks to cut the mechanical royalty rate by over one-third. DiMA also proposed minima of either 4.8 or 3.3 cents for tracks sold as bundles, which if applied would cut mechanical royalties by approximately 50-60%.

80. In support, DiMA relied on industry expert and economist Margaret Guerin-Calvert in both the direct and rebuttal phases of the proceeding. On direct, Ms. Guerin-Calvert offered DiMA's only benchmarks: principally, the 1981 Decision and a recent settlement agreement concerning mechanical and performance royalties in the U.K. (the "U.K. Settlement"), as well as a smattering of other agreements reached between the parties, including the agreement reached 1997 that set the current statutory rate (the "1997 Agreement") and the 2001 Agreement in which the Copyright Owners licensed the RIAA to operate subscription services (the "2001 Agreement").

81. Ms. Guerin-Calvert's own view of the 1981 Decision benchmark says it best: having relied on it on direct, she rejected it on rebuttal. 5/6/08 Tr. at 4865 (Guerin-

Calvert). Like Professor Teece, Ms. Guerin-Calvert conceded that the market today is fundamentally different from that before the CRT. Guerin-Calvert WDT (DiMA Trial Ex. 7) at 19, 15-23; 2/26/08 Tr. at 4557-58 (Guerin-Calvert). And like Professor Teece, Ms. Guerin-Calvert assumed that the average actual price in 1980 was the equivalent of the retail list price—a faulty assumption that completely undermines her derived range of rates of 4-6% from which she selected DiMA’s proposed rates. Guerin-Calvert WDT (DiMA Trial Ex. 7) at 13; see also 2/26/08 Tr. at 4558-60 (Guerin-Calvert).

82. On direct, Ms. Guerin-Calvert also relied on the U.K. Settlement—a benchmark she deemed “most relevant” at trial despite having relegated it to footnotes and an appendix in her written testimony. 2/25/08 Tr. at 4478 (Guerin-Calvert). But of course, as discussed above, the U.K. Settlement is far from relevant. It involves a different licensing system, a different market, a “different package of rights,” and different revenue bases, among other important distinctions, which Ms. Guerin-Calvert conceded. Guerin-Calvert WDT (DiMA Trial Ex. 7) at 10 n. 7. Nor does the U.K. Settlement—setting an 8% royalty rate—come close to supporting Ms. Guerin-Calvert’s range of 4-6%. Ms. Guerin-Calvert’s other “benchmark” agreements—some of which were, literally, *rateless*, pending the outcome of this proceeding—provide no greater guidance as to the determination of an appropriate mechanical royalty rate. *See, e.g.*, 2/26/08 Tr. at 4531, 4534-36, 4567 (Guerin-Calvert)

83. At the end of the day, Ms. Guerin-Calvert’s testimony boiled down mostly to ideas for the Court to consider. Specifically, Ms. Guerin-Calvert asked the Court to set rates “sufficiently flexible” to allow for a variety of business models and to “take into account the high level of consumer price sensitivity” even though Ms. Guerin-Calvert

offered not a speck of empirical evidence in support of her claims. Guerin-Calvert WDT (DiMA Trial Ex. 7) at 6-7.

84. DiMA offered a host of other arguments in support of its dramatic rate reduction, none of which finds support in the record. Contrary to DiMA's claim that the digital market is nascent, the digital market is seven years strong, during the last five of which Apple has enjoyed great success in the permanent download market. Simply put, the digital market is booming and predicted to continue on that path. *See generally* Guerin-Calvert WDT (DiMA Trial Ex. 7) at 48-53.

85. DiMA's contention that a rate cut is needed to allow for new market entrants and to protect current providers is equally lacking in factual support. Numerous providers have entered—and stayed in—the permanent download market under the current penny rate, some even offering consumers lower retail prices than Apple. 5/7/08 Tr. at 4831 (Guerin-Calvert). And Apple has thrived in just such an environment, earning ample profit to cover the costs of the Copyright Owners' proposed increase with plenty of profit remaining. Indeed, although Apple's Vice President of iTunes claimed in written testimony to require a rate cut, he conceded at trial that Apple does not need a rate reduction to sell permanent downloads, to sell them profitably or to grow its business and the permanent download market significantly. *See* 2/25/08 Tr. at 4296, 4310-12 (Cue).

The Copyright Owners' Proposed Terms

86. In addition to seeking increases in the mechanical royalty rates, the Copyright Owners also seek terms necessary to ensure, among other things, that the Copyright Owners receive timely and full payment of royalties. To that end, the Copyright Owners seek terms setting (A) a late fee of 1.5%; (B) a pass-through licensing assessment of 3%; (D) reasonable attorneys fees for amounts expended to collect past due

royalties and late fees; (E) clarification of the applicability of rates; and (F) specific licensing and reporting requirements. Each proposed term is supported by ample record evidence. In the Matter of Mechanical and Digital Phonorecord Delivery Rate Adjustment Proceeding, *Written Direct Statement of Copyright Owners*, Docket No. 2006-3 CRB DPRA (November 30, 2006), at 12.

87. For example, throughout the proceeding, witnesses for the RIAA acknowledged that the record labels frequently make incomplete and late royalty payments to Copyright Owners—delays and deficiencies often uncovered only through extensive audits, conducted by HFA and known as Royalty Compliance Examinations (“RCEs”), at great expense to music publishers. An analysis of HFA cash receipt data for mechanical royalties from January 1, 2000 to September 5, 2007 confirmed the magnitude of the labels’ late payment problem, revealing that over 41,000 receipts totaling more than \$2.1 billion were received by HFA after their due date. Pedecine WRT (CO Trial Ex. 394) at 5. The receipts in question were, on average, 80 days late and represented over 70% of the mechanical royalties received by HFA during that time period. And through its RCEs, HFA recovered \$430 million in additional royalty payments from 1990 to 2007—an amount that represents approximately 6.2% of HFA’s total receipts from licensees for that period. *Id.* at Ex. A.

88. Several record company executives confessed to their late payment problem. And although the RIAA complains that the 1.5% fee proposed by the Copyright Owners is a “high fee” for late payments, all four of the major record labels receive late fees of at least 1.5% per month in their own contracts with digital music services. *See, e.g.*, CO Trial Ex. 91 at DiMA 3448, CO Trial Ex. 92 at DiMA 3902.

Indeed, one record company CFO testified that he could conceive of no commercial reason why the Copyright Owners should not be entitled to the same late payment term that record companies obtain in their contracts. 2/14/08 Tr. at 3257-58 (C. Finkelstein).

89. The Copyright Owners also showed that they suffer from the so-called “pass-through licensing arrangements” that allow record companies to “pass through” mechanical licenses to digital music services to distribute musical works. 5/19/08 Tr. at 7050 (Pedicine). HFA’s Chief Financial Officer demonstrated that the indirect relationship between HFA and the digital music services delays payment to Copyright Owners and impairs HFA’s ability to conduct complete and thorough audits of the digital services.

90. The Copyright Owners’ proposed term concerning specific licensing and reporting is similarly justified. Indeed, Sony BMG’s Vice President of Business Operations and Administration acknowledged that Sony BMG already provides the exact information that the Copyright Owners request in their proposed term. 5/19/08 Tr. at 7105 (Pedicine).

II. Background

A. The Participants

1. The Copyright Owners

91. The Copyright Owners are the SGA, the NSAI and NMPA, which represent the interest of songwriters and music publishers who own the musical works copyright subject to license under Section 115.

(a) The SGA

92. The SGA is the nation’s oldest and largest organization run exclusively by and for songwriters. 1/28/08 Tr. at 196-97 (Carnes). Founded in 1931, the SGA is an

unincorporated voluntary association of approximately 3,500 to 5,000 songwriters and songwriter estates throughout the United States. *Id.*

93. The SGA provides many important services in support of songwriters, both educational and economic. Through its non-profit Foundation, the SGA offers songwriters all across the country creative support in the form of workshops, seminars, competitions and other opportunities for writers to hone and shape their craft. Carnes WDT (CO Trial Ex. 1) at 2. Songwriters also benefit from the SGA educational programs covering topics as diverse as how to understand the structure of a changing music business, how to protect songwriter royalty income, and how to safeguard copyrights and other legal rights. *Id.* In addition, the SGA engages in outreach to songwriters in need and maintains programs to illustrate the important role that music plays in the historical and cultural enrichment of the United States. *Id.*

94. The SGA also provides royalty administration services to songwriters, including assistance with publishing, licensing, royalty collection and distribution, audits of music publishers and catalog administration. *Id.*; 1/28/08 Tr. at 197 (Carnes). Further, the SGA champions songwriters' interests before Congress. For example, the SGA was involved in recent efforts to reform Section 115 of the Copyright Act, and to strengthen legislative anti-piracy efforts. 1/28/08 Tr. at 198 (Carnes).

95. One of the SGA's primary objectives is to ensure that those who devote their careers to songwriting earn royalties adequate to support themselves and their families. Carnes WDT (CO Trial Ex. 1) at 1-2. Consistent with that objective, the SGA has represented the interests of songwriters and other copyright owners in prior industry-wide mechanical royalty rate negotiations, including the 1997 negotiations, the 1987

negotiations and the 1980 proceeding before the Copyright Royalty Tribunal that led to the 1981 Decision.³ *See* Israelite WDT (CO Trial Ex. 11), CO Exs. 11, 15.

(b) The NSAI

96. The NSAI is a trade organization dedicated to providing legal and economic advocacy for, and creative support to, songwriters. It was established in 1967, and although it originally focused on assisting the Nashville songwriting community, today it is increasing its presence in the California and Texas songwriting communities. The NSAI serves songwriters of all genres. Bogard WDT (CO Trial Ex. 2) at 3-5.

97. The NSAI offers a wide array of services to its approximately 5,000 songwriter members, including hosting workshops to teach them the art of songwriting and organizing festivals to showcase their talents. *Id.* at 4. In particular, the NSAI seeks to help aspiring songwriters. For example, the NSAI sponsors a Song Evaluation Service, where new songwriters can send in songs to be critiqued by professional, published songwriters, as well as educational retreats and Song Camps, and also organizes showcases such as “Pitch-to-Publisher Nights.” *Id.*; *see also* Shaw WDT (CO Trial Ex. 5) at 3 (NSAI offers non-professional songwriters “pitch opportunities” and “songwriting critiques”).

98. The NSAI also engages in lobbying and legislative advocacy on behalf of songwriters. The NSAI spearheaded the Songwriters Capital Gains Equity Act, a bill that allows songwriters to pay the same tax rate on catalog sales as their corporate partners, which was passed in 2006. A special focus of the NSAI’s legislative campaign is fighting piracy. Bogard WDT (CO Trial Ex. 2) at 5. Over the years, its members have

³ The SGA participated in the 1980-81 CRT proceeding under a predecessor name, the American Guild of Authors and Composers.

made over 2,000 individual visits to Congress, many with the express purpose of educating Congressional representatives about copyright protection Internet piracy.

Bogard WDT (CO Trial Ex. 2) at 5; Shaw WDT (CO Trial Ex. 5) at 3.

99. In addition, the NSAI has also represented the interests of songwriters and other copyright owners in prior mechanical rate proceedings and negotiations, including the 1980 proceeding before the CRT.

(c) NMPA and HFA

100. NMPA is the principal trade association of music publishers in the United States. It is the leading voice for the American music publishing industry before Congress, in the courts, in the music industry and to the listening public. *See* Israelite WDT (CO Trial Ex. 11) at 3. Founded in 1917, NMPA has approximately 750 members, which own or control the majority of musical compositions available for licensing in this country. *Id.*; *see also* 2/4/08 Tr. at 1379 (Israelite).

101. For over 40 years, NMPA has represented the rights of music publishers and, through them, songwriters, in litigation, legislation, industry-wide negotiations and rate-setting proceedings, including the 1980 proceeding before the CRT and the 1987 and 1997 mechanical royalty rate negotiations that culminated in industry-wide settlements concerning physical phonorecords and digital phonorecord deliveries (“DPDs”). Israelite WDT (CO Trial Ex. 11) at 2-3; Robinson WDT (CO Trial Ex. 8) at 2-4. NMPA’s representation of music publishers before Congress includes, for example, NMPA’s involvement in efforts to reform Section 115 of the Copyright Act. 2/5/08 Tr. at 1524 (Israelite).

102. NMPA took a leading role in a number of high-profile music piracy lawsuits over the past few years, including those against the illegal Napster and Grokster

services. Israelite WDT (CO Trial Ex. 11) at 3. NMPA has also sought to stem online music piracy by promoting legitimate digital music alternatives. *Id.*; *see also* 2/4/08 Tr. at 1381-1382 (Israelite); Robinson WDT (CO Trial Ex. 8) at 3. For example, NMPA entered into agreements with the RIAA and digital music companies that allowed some of the first legitimate online music services to enter the marketplace, even in the absence of an agreement with respect to the applicable royalty rates. Israelite WDT (CO Trial Ex. 11) at 3; *see also id.*, CO Exs. 3, 45-49; Robinson WDT (CO Trial Ex. 8) at 8; 1/31/08 Tr. at 935 (Robinson); 1/29/08 Tr. at 413-14 (Faxon).

103. NMPA's licensing affiliate, HFA, was established in 1927 and serves as a licensing and collecting agent on behalf of its over 35,000 publisher-principals. Israelite WDT (CO Trial Ex. 11) at 4; Pedecine WRT (CO Trial Ex. 394) at 1. HFA is by far the largest U.S. agency involved in licensing copyrighted musical compositions for reproduction and distribution. Israelite WDT (CO Trial Ex. 11) at 4. HFA is authorized by its affiliated publishers to collect and distribute royalties and also serves as an information source, clearinghouse and monitoring service for publishers and licensees. *Id.*

104. HFA is funded by the commissions it charges on royalties distributed to music publishing companies, and a portion of the commissions paid by publishers support NMPA. Santisi WRT (RIAA Trial Ex. 78), Ex. 127-RP at 1; *see also* 1/31/08 Tr. at 949-950 (Robinson). As NMPA President and CEO David Israelite explained during the direct case hearing in this proceeding, through such commissions, songwriters and music publishers "are paying the administrative expense of licensing," because the HFA "commission is mostly to cover the expense of doing the licensing process for the

[copyright] user, whether it be a record label or a DiMA company.” 2/5/08 Tr. at 1400 (Israelite).

105. HFA has developed a convenient and efficient system for licensing copyrighted works. Israelite WDT (CO Trial Ex. 11) at 4; *see also* 2/4/08 Tr. at 1383-1384 (Israelite). Over 13.9 million licenses are under HFA’s administration, and HFA has over 1.9 million songs in its catalog available for licensing. Santisi WRT (RIAA Trial Ex. 78), Ex. 127-RP at 1. In 2007, HFA issued almost 1.52 million mechanical licenses, and over 80% of these licenses were requested and executed electronically. *Id.* at 2. HFA is developing new web applications to make the licensing process even quicker and more efficient, and is continuing to improve the technological tools it currently makes available to publishers, licensees and its own employees. *Id.*

106. As described in more detail below, HFA’s Collections Department monitors licensees’ use and distribution of recordings and encourages them to pay mechanical royalties promptly. Pedecine WRT (CO Trial Ex. 394) at 5-6. In addition, HFA also conducts audits of record companies to ensure that publishers and songwriters are being paid the full amount earned by their songs. *Id.* at 6-12. Centralizing this process in HFA shifts the burden from music publishers, allowing them to focus on the creative process and other business opportunities. Israelite WRT (CO Trial Ex. 11) at 4. HFA-led audits have, over the years, uncovered many millions of dollars in unpaid mechanical royalties. “[F]rom 1990 through 2007, HFA collected, in total, over \$430 million through audits of licensees.” Pedecine WRT (CO Trial Ex. 394) at 6.

2. The Copyright Users

107. The Copyright Users include record companies, who are represented by RIAA, and digital music providers, who are represented by DiMA. In addition, certain DiMA companies are individually participating in this proceeding, as identified below.

(a) The RIAA

108. The RIAA is the primary trade association for the U.S. recording industry. Its members are record companies, including the four “major” record companies: Warner Music Group (“Warner”), Universal Music Group (“Universal”), EMI Music (“EMI”) and Sony BMG Music Entertainment (“Sony BMG”). These record companies are involved in the creation and manufacture of sound recordings, and in the distribution of such recordings through physical and digital retail channels in various formats.

(b) DiMA and Its Individual Participant Members

109. DiMA is a national trade organization that represents member companies in the online audio and video industries. DiMA is currently joined as a participant in this proceeding by four of its members: AOL, LLC (“AOL”); Apple Inc. (“Apple,” f/k/a Apple Computer, Inc.); MediaNet Digital, Inc. (“MediaNet,” f/k/a MusicNet, Inc.); and RealNetworks, Inc. (“RealNetworks”), which have each filed individual petitions to participate. Two other DiMA members, Napster, LLC (“Napster”) and Yahoo!, Inc. (“Yahoo!”), each filed individual petitions to participate and joined DiMA’s Written Direct Testimony, but both withdrew from the proceeding during 2007, prior to the direct case hearings. DiMA’s members are involved in the digital distribution of music through a variety of means more fully described herein, as is relevant.

3. Royalty Logic, Inc.

110. Royalty Logic, Inc. (“Royalty Logic”) was founded to negotiate, license, collect and distribute royalties generated from the digital delivery of sound recordings. Royalty Logic filed a petition to participate in this proceeding with respect to the designation of common agents under 17 U.S.C. § 115(c)(3)(B) and a written direct statement in this case stating that it was participating in this proceeding only “on the issue of competition among agents for the licensing of musical works and/or the collection and distribution of royalties, on behalf of copyright owners and/or their agents” (the “RLI Issue”). Written Direct Statement of Royalty Logic Docket No. 2006-CRB DPRA (Nov. 28, 2006), at 1.

111. On December 3, 2007, counsel for the Copyright Owners executed a joint stipulation with Royalty Logic (the “Stipulation”), which Royalty Logic subsequently filed with the CRJs. Joint Stipulation Regarding Participation by Royalty Logic, Inc. in the Above-Captioned Proceeding, Docket No. 2006-3 CRB DPRA (Dec. 3, 2007). The Stipulation provides, in relevant part, that the Copyright Owners “do not understand the RLI Issue to be within the scope of this proceeding and have not and do not intend to raise the RLI issue in this proceeding.” *Id.* at 1.

112. Under the terms of the Stipulation, Royalty Logic agreed that it would “not participate in the remaining steps in the proceeding, and w[ould] not take part in the direct case hearings, rebuttal case hearings, or closing arguments, unless the Copyright Owners or any other participant in the proceeding raise[d] the RLI Issue” *Id.* at 2. The RLI Issue has not been raised in this proceeding, and, consequently, Royalty Logic did not participate in the direct case hearings or the rebuttal case hearings.

B. The Products At Issue

113. In today's music market, as is relevant here, music is distributed as physical product ("physical phonorecords") or through digital transmission ("DPDs").

114. In the marketplace today, most of the physical phonorecords sold are compact discs ("CDs"). CO Trial Ex. 29 at CO 9008767. Physical phonorecords also include cassette tapes, vinyl LPs and other specialty products such as Minidiscs, Super Audio CDs and DVD-Audio discs. *See id.*

115. The Copyright Act defines a DPD as "each individual delivery of a phonorecord by digital transmission of a sound recording which results in a specifically identifiable reproduction by or for any transmission recipient of a phonorecord of that recording." 17 U.S.C. §115(d). Permanent downloads, limited downloads, interactive streams and ringtones are all DPDs.⁴

116. A permanent download is the digital delivery of a sound recording and the underlying musical work without any limits on the number of times or period of time in which that sound recording can be played by the consumer. Enders WDT (CO Trial Ex. 10) at 4; *see also* Mayer-Patel WRT (CO Trial Ex. 403) at 8. With each download, "the consumer buys, for permanent ownership, a song which is downloaded over the Internet to the PC for either storage on the PC or transfer to a portable device, like an iPod." 2/4/08 Tr. at 1159 (Enders). Permanent downloads are also available for purchase over mobile networks on wireless devices, such as cellular telephones. 2/4/08 Tr. at 1169 (Enders).

⁴ As discussed below in more detail, the Copyright Owners believe that ringtones are not within the parameters of Section 115, and have appealed an October 16, 2006 decision of the Register of Copyrights, which held that ringtones that are merely excerpts of a preexisting sound recording fall within the scope of the statutory license.

117. A ringtone is a digital audio file that is downloaded to a mobile phone or similar portable device in order to personalize the ring that alerts the consumer to an incoming call or message. Enders WDT (CO Trial Ex. 10) at 4; Rosen WDT (RIAA Trial Ex. 63) at 1. Monophonic ringtones are rudimentary works that contain only a musical work's melody (or a portion of the melody). Rosen WDT (RIAA Trial Ex. 63) at 3. Polyphonic ringtones contain a musical work's melody and harmony (or a portion thereof). *Id.* at 4. Mastertones are ringtones that are derived from full-length sound recordings. 5/21/08 Tr. at 7662 (Finell).

C. The History of the Mechanical Royalty Rate

1. 1909-1977

118. In the Copyright Act of 1909, Congress, acting in response to concerns regarding monopolization of musical works by manufacturers of player piano rolls, set the statutory rate for reproducing and distributing musical works at 2 cents per musical work. This rate did not change until 1978, almost seventy years later, when, through the Copyright Act of 1976, Congress increased rates to 2.75 cents per work and established a rate adjustment mechanism. *See* 17 U.S.C. § 115.

2. The 1980 Proceeding

119. The first—and only—contested proceeding to set the mechanical royalty rate took place before the CRT in 1980. *See* 1981 CRT Determination. During that proceeding, copyright owners were represented by, among others, NMPA and the NSAI, and copyright users were represented primarily by the RIAA. *Id.* at 10466. After an evidentiary hearing that included 46 days of testimony and argument, the CRT established a compulsory rate for physical phonorecords equal to the larger of 4 cents or

.75 cents per minute of playing time or fraction thereof, with scheduled increases in 1983, 1984 and 1986. *See* 37 C.F.R. § 255.3; *see also* 46 F.R. 62267-02. Pursuant to the CRT's determination, by 1986 the rate had been increased to 5 cents per track or .95 cents per minute of playing time or fraction thereof. *See* 37 C.F.R. § 255.3.

3. The 1987 Settlement

120. In 1987, pursuant to a joint proposal by NMPA, the SGA and the RIAA, the CRT established a schedule of rate increases indexed for inflation based on the CPI every two years over the next 10 years, except that rates could not be decreased below 1986-1987 levels or increased in any single adjustment by more than 25 percent. *See* 37 C.F.R. § 255.3; *see also* 52 F.R. 23546; 52 F.R. 22637. Over the following decade, the rate steadily increased until 1996, when it reached 6.95 cents per track or 1.3 cents per minute of playing time or fraction thereof. *See id.*

4. The 1997 Settlement

121. The current mechanical royalty rates for physical phonorecords arise out of the 1997 Agreement between NMPA and the SGA, on behalf of copyright owners, and the RIAA, on behalf of copyright users. *See* Robinson WDT (CO Trial Ex. 8) at 3. The rates reflected in the 1997 Agreement provided for increases over the ten-year period it covered that have had the effect of the rate keeping pace with inflation. *Israelite WDT* (CO Trial Ex. 11) at 7-8; *see also* 1/31/08 Tr. at 929 (Robinson). Pursuant to the 1997 Agreement, the mechanical royalty rate for physical phonorecords as of January 1, 2006 is the larger of 9.1 cents per track or 1.75 cents per minute of playing time or fraction thereof. 1/31/08 Tr. at 929 (Robinson).

122. Congress confirmed that DPDs require mechanical licenses in the 1995 Digital Performance Right in Sound Recordings Act (“DPRA”). Pub. L. 104-39, 109 Stat. 336. As part of the 1997 Agreement, the parties agreed to propose rates for DPDs in the form of permanent downloads, but did not address the rates for other digital uses. *See* Israelite WDT (CO Trial Ex. 11) at 9; *see also* 1/31/08 Tr. at 932, 934 (Robinson).

123. At the time, the market for the digital distribution of music was in its infancy and the Copyright Owners had no empirical or economic evidence that would have enabled them to value accurately the future of digital distribution of music. Given this uncertainty, and in order to avoid the substantial costs associated with a litigated rate-setting proceeding, the Copyright Owners agreed to accept physical rates for permanent downloads, although that rate was expressly stated to be non-precedential for future proceedings. Israelite WDT (CO Trial Ex. 11) at 9; *see also* Robinson WDT (CO Trial Ex. 8) at 5.

124. Rates for permanent downloads, as well as the rates for the reproduction and distribution of physical phonorecords, were embodied in a joint petition submitted by NMPA, the SGA, and the RIAA to the Copyright Office on November 5, 1997. Israelite WDT (CO Trial Ex. 11) at CO Ex. 11. After further proceedings with respect to rates and terms for permanent downloads, the parties to the joint proposal reaffirmed their agreement on October 13, 1998. Israelite WDT (CO Trial Ex. 11) at 9, CO Ex. 7.

5. The 2001-2002 Agreements

125. Beginning in 2001, the parties addressed the licensing of limited downloads or interactive streaming and entered into a series of agreements allowing record companies and digital music services immediately to use musical works and pay Copyright Owners for those uses later once an appropriate mechanical rate had been set.

See Israelite WDT (CO Trial Ex. 11), CO 3 (Agreement between the RIAA and NMPA and HFA, dated Oct. 5, 2001); CO 45 (Agreement Concerning the Licensing of Certain Internet Music Subscription Services between Napster, LLC and HFA, dated May 19, 2003); CO 46 (Amendment to the Agreement Concerning the Licensing of Certain Internet Music Subscription Services between Full Audio Corporation and HFA, dated Feb. 21, 2003); CO 47 (Agreement Concerning the Licensing of Certain Internet Music Subscription Services between Full Audio Corporation and HFA, dated March 25, 2002); CO 48 (Agreement Concerning the Licensing of Certain Internet Music Subscription Services between Listen.com and HFA, dated November 9, 2001). These agreements provided for the payment of minimal advances to the Copyright Owners, and stated that the royalty rate would be set either through negotiation or a formal rate-setting proceeding. *See id.* As discussed above, on May 15, 2008, the Copyright Owners and the Copyright Users notified the Court that they had entered into a partial settlement to set rates and terms for limited downloads and interactive streaming in this proceeding for the rate period at issue.

D. The History of the Proceeding

1. The Initiation of the Proceeding

126. On January 9, 2006, the Copyright Royalty Judges (“CRJs”) published a Notice in the Federal Register announcing the commencement of a proceeding to determine rates and terms for the statutory license set forth in Section 115 of the Copyright Act. 71 Fed. Reg. 1545 (Jan. 9, 2006). On February 14, 2006, the CRJs announced a three-month voluntary negotiation period. Because the parties were unable

to reach a voluntary agreement, the Court set November 30, 2006 as the deadline for filing written direct statements in this proceeding.

127. On November 30, 2006, the following parties filed written direct statements: the Copyright Owners, the RIAA, and DiMA (joined by AOL, Apple, MediaNet, Napster, RealNetworks and Yahoo! as individual participants), as well as Royalty Logic.

128. Yahoo! withdrew from the proceeding on August 24, 2007. Notice of Withdrawal, Docket No. 2006-3 CRB DPRA (Aug. 24, 2007). Napster withdrew from the proceeding on October 19, 2007. Notice of Withdrawal, Docket No. 2006-3 CRB DPRA (Oct. 19, 2007).

2. The Ringtone Referral

129. On August 1, 2006, the RIAA moved for referral to the Register of Copyrights (the “Register”) pursuant to 17 U.S.C. § 802(f)(1) the question whether distribution of a “mastertone” by means of digital transmission is a DPD licensable under Section 115. Motion of RIAA Requesting Referral of a Novel Material Question of Substantive Law, Docket No. 2006-3 CRB DPRA (Aug. 1, 2006) (the “Referral Motion”). The Copyright Owners opposed the Referral Motion on the grounds that it presented mixed questions of law and fact. Opposition of NMPA, SGA and NSAI to Motion of RIAA Requesting Referral to the Register of Copyrights, Docket No. 2006-3 CRB DPRA (Aug. 8, 2006).

130. On September 14, 2008, the CRJs referred two questions to the Register: whether ringtones (whether monophonic or polyphonic, or mastertones) constitute DPDs subject to statutory licensing under Section 115, and, if so, what are the legal conditions

and/or limitations on such statutory licensing. Order Granting in Part the Request for Referral of a Novel Question of Law, Docket No. 2006-3 CRB DPRA (Aug. 18, 2006).

131. On October 4, 2006, the Copyright Office held a hearing on these questions. Transcript of Oral Argument, *In re Mechanical and Digital Phonorecord Delivery Rate Adjustment Proceeding*, Docket No. RF 2006-1 (Oct. 4, 2006).

132. The Register issued a decision on October 16, 2006. *In re Mechanical & Digital Phonorecord Delivery Rate Adjustment Proceeding*, Docket No. RF 2006-1 (Register of Copyrights Oct. 16, 2006), *published at* 71 Fed. Reg. 64303 (Nov. 1, 2006) (the “Ringtones Opinion”). In that ruling, the Register held, “we believe that ringtones (including monophonic and polyphonic ringtones, as well as mastertones) qualify as digital phonorecord deliveries (“DPDs”).” *Id.* at 64303. The Register went on to state, however, that “whether a particular ringtone falls within the scope of the statutory license will depend primarily upon whether what is performed is simply the original musical work (or a portion thereof), or a derivative work (*i.e.*, a musical work based on the original musical work but which is recast, transformed, or adapted in such a way that it becomes an original work of authorship and would be entitled to copyright protection as a derivative work).” *Id.* The Register expressly stated “that Section 115, by its terms, concerns only the rights to reproduce and distribute phonorecords of works, leaving derivative works outside its confines.” *Id.* at 64310. Thus, according to the Register, with respect to ringtones that “contain a portion of the full length musical work” and other additional material, that “[t]he determination of whether such a ringtone . . . results in a copyrightable derivative work is a mixed question of fact and law that is beyond the scope of this proceeding,” and “the[] status [of such ringtones] as derivative works need

not be determined in this proceeding, but are more appropriately determined on a case-by-case basis by the courts.” *Id.* at 64313.

133. Notwithstanding the jurisdictional limits recognized by the Register, she nonetheless determined that certain mastertones “simply copy a portion of the underlying musical work and cannot be considered derivative works because such excerpts do not contain any originality and are created with rote editing.” *Id.* at 64312. According to the Register, “[r]ingtones that are merely excerpts of a preexisting sound recording fall squarely within the scope of the statutory license, whereas those that contain additional material may actually be considered original derivative works and therefore outside the scope of the Section 115 license.” *Id.* at 64304.

134. The Copyright Owners have appealed the Register’s Ringtones Opinion to the United States Court of Appeals for the District of Columbia Circuit (“D.C. Circuit”) on the grounds, among others, that the Opinion exceeds the Register’s jurisdiction and authority and violates applicable statutes. Petition for Review and Notice of Appeal, *NMPA, Inc., et al. v. Library of Congress, et al.*, Docket No. 06-1378 (D.C. Cir. Nov. 15, 2006). The Copyright Owners sought direct review of the Ringtones Opinion but subsequently moved the D.C. Circuit to place the appeal in abeyance pending the resolution of the proceeding before the CRJs. Motion to Hold Proceedings in Abeyance, *NMPA, Inc., et al. v. Library of Congress, et al.*, Docket No. 06-1378 (D.C. Cir. Dec. 18, 2006). In that motion, the Copyright Owners requested that the appeal be held in abeyance because, should they appeal the CRJs’ decision in this proceeding in the D.C. Circuit, any review of that decision will include review of the Ringtones Opinion, and judicial efficiency would be aided by conducting both reviews at the same time. *Id.* at 2.

On March 26, 2007, the D.C. Circuit issued a *per curiam* order granting the motion to hold the appeal in abeyance pending the resolution of the rate-setting proceeding before the CRJs. Order, *NMPA, Inc., et al. v. Library of Congress, et al.*, Docket No. 06-1378 (D.C. Cir. Mar. 26, 2007).

3. The Direct Case Hearings

135. The direct case hearing began on Monday, January 28, 2008 and concluded on Tuesday, February 26, 2008. The direct portion of the proceeding included 17 trial days.

(a) Witnesses for the Copyright Owners' Direct Case

136. During the direct phased of the proceeding, the Copyright Owners presented oral testimony from 11 fact witnesses (six songwriters and five representatives of the music publishing industry) and three expert witnesses.

137. Rick Carnes has served as the President of the SGA since 2003. He has been a songwriter for over 30 years and has written many hit songs, including songs performed by Reba McEntire and Garth Brooks that reached number one of the country charts. Carnes WDT (CO Trial Ex. 1) at 1, 3. Mr. Carnes testified before the Court during the direct phase of this proceeding on Monday, January 28, 2008. 1/28/08 Tr. at 194-248 (Carnes); *see also* Carnes WDT (CO Trial Ex. 1).

138. Steve Bogard has served as the President of the NSAI since 2006, and has also represented the interests of songwriters in other music industry organizations, including the American Society of Composers, Authors and Publishers (“ASCAP”), the Country Music Association (“CMA”) and the National Academy of Recording Arts and Sciences (“NARAS”). For more than 40 years, Mr. Bogard has written songs—including

eight number one country hits—that have been recorded by top country artists, such as George Strait, Waylon Jennings and Conway Twitty. Bogard WDT (CO Trial Ex. 2) at 2-3. Mr. Bogard testified before the Court during the direct phase of this proceeding on Monday, January 28, 2008. 1/28/08 Tr. at 249-78 (Bogard); *see also* Bogard WDT (CO Trial Ex. 2).

139. Phil Galdston has been a “pure” songwriter for over 30 years. He has written pop hits for a number of artists, including Celine Dion, Beyonce and Vanessa Williams (including the ASCAP award-winning song “Save the Best for Last”). Mr. Galdston teaches music at New York University and serves on the board of the New York chapter of NARAS. He has advocated songwriters’ interests in a number of fora, including before Congress. Galdston WDT (CO Trial Ex. 4) at 1-3. Mr. Galdston testified before the Court during the direct phase of this proceeding on Wednesday, January 30, 2008. 1/30/08 Tr. at 775-811 (Galdston); *see also* Galdston WDT (CO Trial Ex. 4).

140. Victoria Shaw is a songwriter (as well as a recording artist and producer) who crafts songs in a variety of genres, including country, pop and Latin. She has been writing songs for over 25 years and has five number one hits to her credit, including two performed by Garth Brooks. Ms. Shaw performs advocacy work on behalf of the songwriting community—such as testifying before Congress—and has taken a leadership role in a variety of music industry organizations, including the CMA and NARAS. 1/30/08 Tr. at 816-18, 821-23 (Shaw). Ms. Shaw testified before the Court during the direct phase of this proceeding on Wednesday, January 30, 2008. *Id.* at 812-861; *see also* Shaw WDT (CO Trial Ex. 5).

141. Maia Sharp is a singer-songwriter who writes and performs country, rock and pop songs. Her professional career began in 1996. Since then, her compositions have been recorded by artists including Cher, Bonnie Raitt and the Dixie Chicks, who took her song “A Home” to number one on the country charts. Sharp WDT (CO Trial Ex. 6) at 2, 4. Ms. Sharp testified before the Court during the direct phase of this proceeding on Thursday, January 31, 2008. 1/31/08 Tr. at 866-897 (Sharp); *see also* Sharp WDT (CO Trial Ex. 6).

142. Stephen Paulus has been an award-winning classical composer for over 30 years. He has written 10 operas and many works for orchestra and chorus. These works have been commissioned by and performed by distinguished opera companies, orchestras and choruses in the United States and around the world, including, for example, the New York Philharmonic. Mr. Paulus has served on the board of ASCAP as the Concert Music Representative since 1990. Paulus WDT (CO Trial Ex. 7) at 3-5. He testified before the Court during the direct phase of this proceeding on Thursday, January 31, 2008. 1/31/08 Tr. at 897-918 (Paulus); *see also* Paulus WDT (CO Trial Ex. 7).

143. David Israelite has been the President and Chief Executive Officer of NMPA since 2005. From 2001 to 2005, he served in the Department of Justice as Deputy Chief of Staff and Counselor to the Attorney General, and as Chairman of the Department’s Task Force on Intellectual Property, which was created in 2004. Prior to that, Mr. Israelite served as the Director of Political and Governmental Affairs for the Republican National Committee and worked for Missouri Senator Kit Bond. He received a J.D. from the University of Missouri in 1994. Israelite WDT (CO Trial Ex. 11) at 2. Mr. Israelite testified before the Court during the direct phase of this proceeding on

Monday and Tuesday, February 4 and 5, 2008. 2/4/08 Tr. at 1368-1385 (Israelite); 2/5/08 Tr. at 1392-1531 (Israelite); *see also* Israelite WDT (CO Trial Ex. 11).

144. Irwin Robinson has served as the Chairman of both NMPA and HFA for 24 years, and has been involved in the music publishing industry for over 50 years. He is currently the Chairman of Paramount Allegra Music. He has held senior executive positions at music publishing companies throughout his career, including stints as President of Chappell/Intersong Music Group, President and CEO of EMI Music Publishing (“EMI MP”) and Chairman and CEO of The Famous Music Publishing Companies (“Famous”), which was purchased by Sony/ATV in 2007. He is a member of the boards of ASCAP and the Songwriters’ Hall of Fame and has also served as a trustee of the U.S. Copyright Society. Robinson WDT (CO Trial Ex. 8) at 1-3; 1/31/08 Tr. at 922, 926-29. Mr. Robinson testified before the Court during the direct phase of this proceeding on Thursday, January 31, 2008. 1/31/08 Tr. at 918-1109 (Robinson); *see also* Robinson WDT (CO Trial Ex. 8).

145. Roger Faxon has been the Chairman and CEO of EMI MP, one of the world’s largest music publishers, since 2006. Mr. Faxon has been in the entertainment industry for 25 years and has been with EMI MP for over 14 years (having served as Chief Financial Officer for both the music publishing division and of EMI Group, which includes the company’s recorded music division). Mr. Faxon also serves on the boards of both NMPA and ASCAP. Faxon WDT (CO Trial Ex. 3) at 1-2. He testified before the Court during the direct phase of this proceeding on Tuesday and Wednesday, January 29 and 30, 2008. 1/29/08 Tr. at 331-538 (Faxon); 1/30/08 Tr. at 543-774 (Faxon); *see also*

Faxon WDT (CO Trial Ex. 3). As described below, Mr. Faxon also testified before the Court during the rebuttal phase of the proceeding.

146. Nicholas Firth is the former Chairman and CEO of BMG Music Publishing Worldwide (“BMG MP”), which was the third largest music publishing company in the world when it merged with Universal Music Publishing Group (“UMPG”) in 2007. Mr. Firth has approximately 45 years of experience in the music publishing industry. Before running BMG MP for 20 years, he worked at Chappell International, serving as its President from 1981 to 1984. In addition, Mr. Firth has served on the boards of the NMPA and ASCAP. Firth WDT (CO Trial Ex. 24) at 1-3; 2/12/08 Tr. at 2623-24. He testified before the Court during the direct phase of this proceeding on Tuesday, February 12, 2008. 2/12/08 Tr. at 2622-2722 (Firth); *see also* Firth WDT (CO Trial Ex. 24).

147. Ralph Peer II is the Chairman and CEO of Peermusic, Inc., an independent international group of music publishing companies with 33 offices in 27 different countries. He has worked for Peermusic, and been involved in the music publishing business, for approximately 40 years. He also serves on the boards of NMPA and HFA, is a lifetime director (and past President) of the CMA, and was formerly a board member of ASCAP and a trustee of the U.S. Copyright Society. Peer WDT (CO Trial Ex. 13) at 1-2. Mr. Peer testified before the Court during the direct phase of this proceeding on Tuesday, February 5, 2008. 2/5/08 Tr. at 1541-1716 (Peer); *see also* Peer WDT (CO Trial Ex. 13).

148. William Landes is the Clifton R. Musser Professor of Law and Economics at the University of Chicago Law School, where he has taught for the past 34 years. He

received his Ph.D. in Economics from Columbia University in 1966. Professor Landes has taught and published extensively on the economic analysis of law, antitrust and intellectual property matters, and has served as an expert witness on such matters in numerous cases. During his career, he co-founded two economics consulting firms, Lexecon and Leaf Group LLC, and is currently the Chairman Emeritus of Compass Lexecon. Landes WDT (CO Trial Ex. 22) at 1-2. Professor Landes testified before the Court during the direct phase of this proceeding on Thursday, February 7, 2008 and Monday, February 11, 2008. 2/7/08 Tr. at 2036-2293 (Landes); 2/11/08 Tr. at 2299-2612 (Landes); *see also* Landes WDT (CO Trial Ex. 22). The Court qualified Professor Landes as an expert in the economic analysis of law, the economics of intellectual property and industrial organization. 2/7/08 Tr. at 2054-55 (Landes). As described below, Professor Landes also testified before the Court during the rebuttal phase of the proceeding.

149. Claire Enders is the CEO of Enders Analysis, an international provider of research, analysis and advice on telecommunications, technology and media, including the music industry. Ms. Enders has worked in the media and entertainment industries for over 20 years. After holding senior executive positions at companies such as The Virgin Group and Thorn EMI plc, she founded Enders Analysis in 1997. Enders WDT (CO Trial Ex. 10) at 1-2. Ms. Enders testified before the Court during the direct phase of this proceeding on Monday, February 4, 2008. 2/4/08 Tr. at 1122-1359 (Enders); *see also* Enders WDT (CO Trial Ex. 10). The Court qualified Ms. Enders as an expert in the development, current state and likely future prospects of the U.S. digital music market. 2/4/08 Tr. at 1135-37 (Enders).

150. Helen Murphy has been the President of International Media Services Inc. (“IMS”), a New York-based strategic advisory and financial services firm, since 2004. IMS has provided consulting services for record companies and music publishing companies in connection with acquisitions and restructurings. Ms. Murphy is a Chartered Financial Analyst with over 15 years experience in the entertainment and media industries, and she has served as the CFO of two record companies, Polygram (1997-1999) and Warner Music Group (2001-2004). H. Murphy WDT (CO Trial Ex. 15) at 1-2. Ms. Murphy testified before the Court during the direct phase of this proceeding on Wednesday and Thursday, February 6 and 7, 2008. 2/6/08 Tr. at 1734-1994 (H. Murphy); 2/7/08 Tr. at 2008-25 (H. Murphy); *see also* H. Murphy WDT (CO Trial Ex. 15). Ms. Murphy was initially qualified by the Court as an expert in the financial affairs and the structure of the recorded music business, *see* 2/6/08 Tr. at 1743-46 (H. Murphy), although the Court subsequently revoked its acceptance of her as an expert and struck portions of her oral and written testimony, *see* Order Striking Certain Witness Testimony and Refusing Witness as Expert, Docket No. 2006-3 CRB DPRA (Feb. 14, 2008). The remainder of Ms. Murphy’s testimony remains part of the trial record. *See id.* at 4.

151. In addition to the witnesses described above, the Copyright Owners also filed written direct testimony from music publisher Bob Doyle and songwriter Jud Friedman, but subsequently withdrew their testimony from the direct case.

(b) Witnesses for the RIAA’s Direct Case

152. During the direct phase of the proceeding, the RIAA submitted oral and written testimony from the following thirteen witnesses.

153. Glenn Barros. 2/21/08 Tr. at 4096-4204 (Barros); Barros WDT (RIAA Trial Ex. 74).

154. Victoria Bassetti. 2/19/08 Tr. at 3841-67 (Bassetti); 2/20/08 Tr. at 3842-3930 (Bassetti); Bassetti WDT (RIAA Trial Ex. 68).
155. Richard Boulton. 2/12/08 Tr. at 2877-2919 (Boulton); 2/13/08 Tr. at 2926-3000 (Boulton); Boulton WDT (RIAA Trial Ex. 54).
156. Andrea Finkelstein. 2/14/08 Tr. at 3220-3424 (A. Finkelstein); A. Finkelstein WDT (RIAA Trial Ex. 61).
157. Colin Finkelstein. 2/13/08 Tr. at 3102-3216 (C. Finkelstein); 2/14/08 Tr. at 3223-3319 (C. Finkelstein); C. Finkelstein (RIAA Trial Ex. 57).
158. David Hughes. 2/20/08 Tr. at 4050-89 (Hughes); Hughes WDT (RIAA Trial Ex. 73).
159. Michael Kushner. 2/14/08 Tr. at 3424-3506 (Kushner); Kushner WDT (RIAA Trial Ex. 62).
160. Linda McLaughlin. 2/13/08 Tr. at 3000-3102 (McLaughlin); McLaughlin WDT ((RIAA Trial Ex. 56).
161. David Munns. 2/26/08 Tr. at 4723-61 (Munns); Munns WDT (RIAA Trial Ex. 76).
162. Jerold Rosen. 2/14/08 Tr. at 3506-51 (Rosen); Rosen WDT (RIAA Trial Ex. 63).
163. Geoffrey Taylor. 2/12/08 Tr. at 2724-2875 (Taylor); Taylor WDT (RIAA Trial Ex. 53).
164. David J. Teece. 2/19/08 Tr. at 3560-3840 (Teece); Teece WDT (RIAA Trial Ex. 64).

165. Ron Wilcox. 2/20/08 Tr. at 3931-4050 (Wilcox); Wilcox WDT (RIAA Trial Ex. 70).

166. In addition, the RIAA filed written direct testimony from Tom McKay, Michael Pollack and Cary Sherman, but subsequently withdrew their testimony from the direct case.

(c) Witnesses for DiMA's Direct Case

167. During the direct phase of the proceeding, DiMA submitted oral and written testimony from the following witnesses:

168. Eddy Cue. 2/25/08 Tr. at 4213-4351 (Cue); Cue WDT (DiMA Trial Ex. 3).

169. Margaret Guerin-Calvert. 2/25/08 Tr. at 4426-4519 (Guerin-Calvert); 2/26/08 Tr. at 4527-85 (Guerin-Calvert); Guerin-Calvert WDT (DiMA Trial Ex. 7).

170. Alan McGlade. 2/25/08 Tr. at 4352-4426 (McGlade); McGlade WDT (DiMA Trial Ex. 5).

171. Timothy Quirk. 2/26/08 Tr. at 4586-4723 (Quirk); Quirk WDT (DiMA Trial Ex. 8).

172. In addition, DiMA filed written direct testimony from Laura Goldberg, Kyle Johnson and Jonathan Potter, but subsequently withdrew their testimony from the direct case.

4. The Rebuttal Hearings

173. On April 10, 2008, NMPA, the RIAA and DiMA filed written rebuttal cases. Witness testimony in the rebuttal phase began on Tuesday, May 6, 2008 and concluded on Wednesday, May 21, 2008. There were ten days of rebuttal witness testimony.

(a) Witnesses for the Copyright Owners' Rebuttal Case

174. During the rebuttal phase of the proceeding, the Copyright Owners submitted oral and written testimony from three fact witnesses affiliated with the music publishing industry and four expert witnesses.

175. As noted above, two of the Copyright Owners' rebuttal witnesses had previously testified during the direct phase of the proceeding: Mr. Faxon, who testified during the rebuttal phase on Wednesday, May 14, 2008 (5/14/08 Tr. at 6318-6579 (Faxon)), and Professor Landes, who testified during the rebuttal phase on Monday and Tuesday, May 19 and 20, 2008 (5/19/08 Tr. at 7109-7253 (Landes); 5/20/08 Tr. at 7259-7545 (Landes)). *See also* Faxon WRT (CO Trial Ex. 375); Landes WRT (CO Trial Ex. 406).

176. The Copyright Owners also presented oral rebuttal testimony from the following five witnesses, who had not testified during the direct case hearing:

177. Alfred Pedecine is Senior Vice President and CFO of HFA. He has worked at HFA since 1999 and was named CFO in 2001. As CFO, he is responsible for the overall financial functions of the company, including financial reporting, planning and cash management, as well as the royalty compliance and collections areas.

Mr. Pedecine has over 25 years of experience in the music industry, and held a number of

senior executive positions at major record labels prior to joining HFA. Pedecine WRT (CO Trial Ex. 394) at 1, 4. Mr. Pedecine testified before the Court during the rebuttal phase of this proceeding on Monday, May 19, 2008. 5/19/08 Tr. at 7027-7108 (Pedecine); *see also* Pedecine WRT (CO Trial Ex. 394).

178. Jeremy Fabinyi is the Managing Director of Mechanicals at the MCPS-PRS Alliance, which is a jointly owned operating company of two U.K. organizations: the Mechanical Copyright Protection Society Limited and the Performing Right Society Limited. He has held various positions at the MCPS-PRS Alliance since 2005. From 2002 to 2005, he worked at an international mechanical rights organization in Paris, and prior to that, he worked in the recording and music publishing industries in Australia. Based on his experience, Mr. Fabinyi is knowledgeable about mechanical royalty rates in many foreign countries. Fabinyi WRT (CO Trial Ex. 380) at 1-4. Mr. Fabinyi testified before the Court during the rebuttal phase of this proceeding on Thursday, May 15, 2008. 5/15/08 Tr. at 6698-6858 (Fabinyi); *see also* Fabinyi WRT (CO Trial Ex. 380).

179. Kevin M. Murphy is the George J. Stigler Distinguished Service Professor of Economics in the Graduate School of Business and the Department of Economics at the University of Chicago, where he has taught since 1983. He received a Ph.D. in economics from the University of Chicago in 1986. At the University of Chicago, Professor Murphy teaches courses in microeconomics, price theory, empirical labor economics, and the economics of public policy issues, and he has authored or co-authored more than sixty-five articles in a variety of areas in economics. In addition, he is a Principal at Chicago Partners, LLC, a consulting firm that specializes in the application of economics to law and regulatory matters, and he has provided expert

testimony on such matters in numerous cases. K. Murphy WRT (CO Trial Ex. 400) at 1-2. Professor Murphy testified before the Court during the rebuttal phase of this proceeding on Thursday, May 15, 2008 and Monday, May 19, 2008. 5/15/08 Tr. at 6859-6966 (K. Murphy); 5/19/08 Tr. at 6977-7026 (K. Murphy); *see also* K. Murphy WRT (CO Trial Ex. 400). The Court qualified Professor Murphy as an expert on microeconomics and the economics of intellectual property. 5/15/08 Tr. at 6869-70 (K. Murphy).

180. Ketan Mayer-Patel is an Associate Professor in the Department of Computer Science at the University of North Carolina, Chapel Hill, where he has taught since 2000. He received a Ph.D. in Computer Science from the University of California, Berkeley in 1999. Professor Mayer-Patel teaches courses in Web Programming and Multimedia Networking, and one of his primary topics of interest for research and teaching is the interactive streaming of audio and video. He has published approximately thirty articles related to multimedia technologies and has almost 20 years of experience with this subject. Mayer-Patel WRT (CO Trial Ex. 403) at 1, 3-5. Professor Mayer-Patel testified before the Court during the rebuttal phase of this proceeding on Wednesday, May 21, 2008. 5/21/08 Tr. at 7554-7651 (Mayer-Patel); *see also* Mayer-Patel WRT (CO Trial Ex. 403). The Court qualified Professor Mayer-Patel as an expert in the technology of media streaming, including audio streaming. *Id.* at 7562-63; 7579.

181. Judith Finell is President of Judith Finell MusicServices Inc., a consulting company she founded in 1976, and a professional musicologist. Today, Judith Finell MusicServices Inc. provides music consulting and expert services for record companies, music publishers, advertising firms, entertainment companies, and technology companies.

She has consulted on, and has served as expert witness with respect to, various disputes regarding intellectual property, including copyright infringement litigation. Finell WRT (CO Trial Ex. 420) at 1-2. Ms. Finell testified before the Court during the rebuttal phase of this proceeding on Wednesday, May 21, 2008. 5/21/08 Tr. at 7652-96 (Finell); *see also* Finell WRT (CO Trial Ex. 420). The Court qualified Ms. Finell as an expert in musicology. *Id.* at 7658-59.

182. In addition to the rebuttal witnesses described above, the Copyright Owners also filed written rebuttal testimony from Maurice Russell, but subsequently withdrew his testimony from the rebuttal case.

(b) Witnesses for the RIAA's Rebuttal Case

183. During the rebuttal phase of the trial, the RIAA submitted oral and written testimony from the following nine rebuttal witnesses:

184. David Alfaro. 5/6/08 Tr. at 4952-5059 (Alfaro); Alfaro WRT (RIAA Trial Ex. 77).

185. Bruce Benson. 5/8/08 Tr. at 5476-5620 (Benson); Benson WRT (RIAA Trial Ex. 82).

186. Robert Emmer. 5/13/08 Tr. at 6251-6309 (Emmer); Emmer WRT (RIAA Trial Ex. 90).

187. Mark Eisenberg. 5/13/08 Tr. at 6039-6137 (Eisenberg); Eisenberg WRT (RIAA Trial Ex. 89).

188. Andrea Finkelstein. 5/12/08 Tr. at 5630-5764 (Finkelstein); Finkelstein WRT (RIAA Trial Ex. 84).

189. Scott Pascucci. 5/7/08 Tr. at 5269-5311 (Pascucci); Pascucci WRT (RIAA Trial Ex. 80).

190. Terri Santisi. 5/7/08 Tr. at 5067-5268 (Santisi); Santisi WRT (RIAA Trial Ex. 78).

191. Daniel Slottje. 5/8/08 Tr. at 5319-5475 (Slottje); Slottje WRT (RIAA Trial Ex. 81).

192. Steven Wildman. 5/12/08 Tr. at 5770-5988 (Wildman); 5/13/08 Tr. at 5995-6039 (Wildman); Wildman WRT (RIAA Trial Ex. 87).

193. In addition, the RIAA filed written rebuttal testimony from Michael Koch, but subsequently withdrew his testimony from the rebuttal case.

(c) Witnesses for DiMA's Rebuttal Case

194. During the rebuttal phase of the proceeding, DiMA submitted oral and written testimony from the following three witnesses:

195. Margaret Guerin-Calvert, who had previously testified during the direct phase of the trial. 5/6/08 Tr. at 4785-4941 (Guerin-Calvert); Guerin-Calvert WRT (DiMA Trial Ex. 10).

196. Alexander Kirk. 5/14/08 Tr. at 6581-6619 (Kirk); 5/15/08 Tr. at 6630-6666 (Kirk); Kirk WRT (DiMA Trial Ex. 14).

197. Dan Sheeran. 5/13/08 Tr. at 6151-6249 (Sheeran); Sheeran WRT (DiMA Trial Ex. 11).

198. In addition, DiMA filed written rebuttal testimony from Timojhen Mark, but subsequently withdrew his testimony from the rebuttal case.

5. The Partial Settlement

199. On May 15, 2008, during the rebuttal case hearing, the Copyright Owners and the Copyright Users notified the CRJs that they had reached a settlement of rates and terms under Section 115 of the Copyright Act in this proceeding for limited downloads and interactive streaming (the “Partial Settlement”).⁵ Joint Motion To Adopt Procedures For Submission of Partial Settlement, Docket No. 2006-3 CRB DPRA (May 15, 2008). The Copyright Owners and the Copyright Users requested that the CRJs authorize them to submit the agreed upon rates and terms on September 15, 2008 or later, if practicable, and also asked to be relieved of their obligations to file proposed findings of fact and conclusions of law concerning those issues. *See id.* at 2-3.

200. On May 27, 2008, the CRJs issued an order granting the joint motion with respect to the request to be relieved of the obligations to file proposed findings of fact and conclusions of law on the settled issues. Order Granting In Part and Denying In Part Joint Motion To Adopt Procedures For Submission of Partial Settlement, Docket No. 2006-3 CRB DPRA (May 27, 2008). In accordance with the May 27 Order and the Partial Settlement, the Participants are not submitting proposed findings of fact and conclusions of law with respect to rates and terms for limited downloads and interactive streaming. Any discussion below of subscription services is solely to provide context for the development, current state and future prospects for the digital music market, or with respect to those companies’ sales of permanent downloads.

⁵ All of the Participants in this proceeding have entered into the Partial Settlement, with the exception of Royalty Logic, which, as described above in Section II.A.3, is participating only with regard to the RLI Issue, and has not submitted a proposal for rates and terms under Section 115.

201. Pursuant to 37 C.F.R. § 351.4, and as discussed below, the Copyright Owners are submitting a revised rate proposal that removes requested rates and terms for limited downloads and interactive streaming. In the Matter of Mechanical and Digital Phonorecord Delivery Rate Adjustment Proceeding, *Amended Proposed Rates and Terms of National Music Publishers' Association, Inc., the Songwriters Guild of America, and the Nashville Songwriters International*, Docket No. 2006-3 CRB DPRA (July 2, 2008) (“Copyright Owners’ Amended Proposal”).

III. The Copyright Owners’ Proposed Rates and Terms⁶

A. Royalty Rates

202. Physical Phonorecords: A penny rate equal to the greater of 12.5 cents per song or 2.40 cents per minute of playing time or fraction thereof, subject to periodic adjustments for inflation, as measured by the Consumer Price Index-Urban Wage Earners and Clerical Workers (U.S. Bureau of Labor Statistics Series CWSR0000SA0) (“CPI”).

203. Permanent Downloads: A penny rate equal to the greater of 15 cents per track or 2.90 cents per minute of playing time or fraction thereof, subject to periodic adjustments for inflation as measured by the CPI.

204. Ringtones: A rate equal to the greatest of:

- a) 15 percent of revenue;
- b) 15 cents per ringtone, subject to periodic adjustments for inflation as measured by the CPI; or

⁶ For the Court’s reference, the amended proposed rates and terms filed by the RIAA and DiMA in connection with the rebuttal case are attached as Appendix A and B. We note that in light of the Partial Settlement, the RIAA and DiMA are no longer seeking the Court to adopt their proposed terms regarding limited downloads or interactive streaming.

- c) one-third of the total content costs paid for mechanical rights to musical compositions and rights to sound recordings.

B. Revenue Definition

205. Revenue shall mean all monies and any other consideration paid or payable to, or received, earned, accrued or derived by, a User by or from any party in connection with a Licensed Service or a Licensed Product, including the fair market value of non-cash or in-kind consideration, including:

- a) All consideration payable for a Licensed Service (including all subscription fees, access charges and any other consideration paid for access to and/or use of all or a portion of the Licensed Service);
- b) All consideration payable for a Licensed Product (including purchase fees);
- c) All consideration from advertising of any kind on the same web page as, in proximity to or on pages leading up to, or used to access, the Licensed Service or Licensed Product (including audio and visual advertising, advertising; sponsor “hot links,” the provision of promotional time, space or services, and all banners, “in-stream,” pre-roll, post-roll, and key-word targeted advertisements);
- d) All consideration from or in the form of promotions and/or sponsorships;
- e) All consideration from e-commerce bounties or click-through royalties, or referral or affiliate program fees or similar such arrangements;
- f) All other consideration paid for services, devices, software or privileges used to access or use the Licensed Service or Licensed Product;
- g) Any revenue share, equity, security or other financial or economic interest transferred or pledged as consideration for a Licensed Service or Licensed Product;
- h) In the case of a Licensed Service or Licensed Product that is sold or distributed in bundled form with another service or product, that proportion of consideration received for the bundle that is represented by the standalone published price of such Licensed Service or Licensed Product in relation to the standalone published

price(s) of the other component(s) of the bundle (if there is no standalone published price, then the average standalone price for the most closely comparable service or product in the U.S., or, if more than one such comparable exists, the average of standalone prices for such comparables, shall be used); and

- i) Any other consideration received or receivable arising in relation to the provision of a Licensed Service or Licensed Product.

206. Licensed Product shall mean a ringtone of a sound recording embodying all or a portion of a musical work.

207. Licensed Service shall mean any digital music service that provides ringtones, whether or not on a subscription basis.

208. Licensor shall mean (i) the copyright owner or grantor of sound recording and/or mechanical rights to a User to exploit a Licensed Service or Licensed Product, or person or entity acting on their behalf; (ii) any entity owned or controlled by, under common control with or affiliated with the Licensor; and (iii) any person or entity that is receiving consideration for the Licensed Service or Licensed Product on behalf of or in lieu of the Licensor.

209. Total Content Costs shall mean each and all of the types of consideration comprising Revenue that are paid or payable to the Licensor of sound recording rights and/or the Licensor of mechanical rights in connection with a Licensed Service or Licensed Product.

210. User shall mean (i) any person or entity that is offering or providing a Licensed Service or Licensed Product directly to consumers as the retailer, whether or not the licensee; (ii) any entity owned or controlled by, under common control with or affiliated with the User; and (iii) any person or entity that is receiving consideration for the Licensed Service or Licensed Product on behalf of or in lieu of the User.

C. Terms

211. Late Fee of 1.5%: Without affecting any right to terminate a license for failure to report or pay royalties as provided in § 115(c)(6), late fees shall be assessed at 1.5% per month (or the highest lawful rate, whichever is lower) from the date payment should have been made (the twentieth day of the calendar month following the month of distribution) to the date payment is actually received by the Copyright Owner.

212. Pass-Through Licensing Assessment of 3%: For pass-through arrangements, there shall be an automatic 3% assessment on all royalty payments by the licensee to address the fact that the Copyright Owners would receive payment sooner if the retailer were paying the Copyright Owners directly (such assessment to be augmented by additional late fees at 1.5% per month if payment by the licensee is otherwise late).

213. Reasonable attorneys' fees expended to collect past due royalties and late fees: A Copyright Owner shall be entitled to recover from the licensee reasonable attorneys' fees expended to collect past due royalties and late fees.

214. Applicability of Rates: The statutory rate to be applied is the rate in effect as of the date of distribution.

215. Specific Licensing and Reporting: Licenses are to be taken by specific configuration (*e.g.*, CD, cassette, permanent download, etc.). In addition to any other applicable requirements, reporting must be broken down by specific configuration (*i.e.*, must detail how many units distributed of a particular configuration, and the applicable rate and royalties due for that configuration) and, in the case of pass-through arrangements, must be further broken down to indicate the retail outlet through which the distribution was made to the end user.

IV. The Songwriting Profession

A. Overview

216. Songwriters contribute the single most important element for recorded music: the song. The NSAI's motto says it best: "It all begins with a song." Bogard WDT (CO Trial Ex. 2) at 6. Without songwriters' critical creative inputs, there would be no musical works for artists to record and for record companies and digital music services to distribute and sell to the public. *See* Galdston WDT (CO Trial Ex. 4) at 8; Shaw WDT (CO Trial Ex. 5) at 4.

217. Because of songwriters' achievements, American music ranks among our nation's greatest artistic achievements. In addition to its cultural significance, American music is a major foundation of the gross national product and the backbone of our entertainment exports to the rest of the world. Carnes WDT (CO Trial Ex. 1) at 1.

218. In today's marketplace, pursuant to their agreements with music publishers, songwriters typically receive 75%—and sometimes as much as 95%—of the mechanical royalties earned from the exploitation of their musical compositions. Peer WDT (CO Trial Ex. 13) at 6-7; 2/5/08 Tr. at 1650-51 (Peer); Robinson WDT (CO Trial Ex. 8) at 19; 1/31/08 Tr. at 971 (Robinson); Faxon WDT (CO Trial Ex. 3) at 7; 1/29/08 Tr. at 502-03 (Faxon). Further, "it is clear that the average publisher's share of royalties is decreasing over time." Peer WDT (CO Trial Ex. 13) at 6; *see also* Robinson WDT (CO Trial Ex. 8) at 19 ("[O]ur agreements with songwriters are typically guaranteeing us a smaller share of any royalties that are eventually earned"). Thus, although virtually ignored by both the RIAA and DiMA throughout the course of this proceeding, songwriters represent the true economic parties in interest in this proceeding and those who will bear the brunt of the drastic rate reductions proposed by the RIAA and DiMA.

219. There are three different types of songwriters. “Pure” songwriters write songs for others to perform and record, and are not themselves performers or recording artists. Peer WDT (CO Trial Ex. 13) at 9; *see also* Galdston WDT (CO Trial Ex. 4) at 1; 1/31/08 Tr. at 943 (Robinson).

220. “Singer-songwriters” are songwriters and recording artists who perform the songs they write. Peer WDT (CO Trial Ex. 13) at 9; *see also* 1/31/08 Tr. at 943 (Robinson). In addition to receiving mechanical royalties for their songwriting, singer-songwriters receive artist royalties from the sale of their sound recordings. 2/5/08 Tr. at 1564 (Peer).

221. “Producer-songwriters” write songs and also perform the functions typically ascribed to music producers, such as selecting and arranging songs, coaching and guiding the performers, and supervising the recording, mixing and mastering processes. Peer WDT (CO Trial Ex. 13) at 9; 1/31/08 Tr. at 943 (Robinson). In addition to receiving mechanical royalties for their songwriting, producer-songwriters receive producer royalties from the sale of the sound recordings they produce.

222. Throughout their careers, all types of songwriters make tremendous sacrifices and significant contributions to make creative works available to the public. As the testimony throughout this proceeding demonstrated, songwriting is a financially risky profession providing only modest returns for even the most successful hit songs. And with declining mechanical royalties in today’s market, songwriters are being forced to leave the profession or are choosing never to enter it—endangering the very foundation of the music industry.

B. Songwriting Is a Demanding and Risky Profession

223. Songwriting is an “incredibly labor intensive” profession. Carnes WDT (CO Trial Ex. 1) at 7; Sharp WDT (CO Trial Ex. 6) at 4 (“Songwriting is a creative art form that requires a lot of work.”); 1/30/08 Tr. at 790 (Galdston) (songwriting requires a “tremendous investment”). As songwriter Victoria Shaw testified, “songwriting in Nashville is treated as a 9 to 5 job” and performed in an office, with fellow writers making appointments to collaborate on songs. Shaw WDT (CO Trial Ex. 5) at 4; 1/30/08 Tr. at 823 (Shaw). When asked to describe the time she spends writing songs, songwriter Maia Sharp testified: “All of it. I am writing all day.” 1/31/08 Tr. at 885 (Sharp). In particular, composing classical pieces takes a long time; for composer Stephen Paulus, it can take a month to write a small choral piece, and an average of 13 to 14 months to write an opera, plus additional months to work with an opera company to finalize and perfect the work. 1/31/08 Tr. at 915 (Paulus); Paulus WDT (CO Trial Ex. 7) at 6.

224. Few songwriters, however, enjoy the luxury of spending all day on their craft. As numerous songwriters testified, they often find it necessary to take on second jobs to survive financially while they try to continue their songwriting careers. *See, e.g.*, Sharp WDT (CO Trial Ex. 6) at 6. Sometimes, songwriters participate in other aspects of the music industry to make a living. Ms. Sharp, for example, works as a back-up singer and a saxophone player in recording sessions, and accompanies other artists on concert tours, to earn extra income. Sharp WDT (CO Trial Ex. 6) at 2; 1/31/08 Tr. at 870 (Sharp). Touring takes a toll on Ms. Sharp’s musical productivity; when she is on tour, she does not write songs, “because the press interviews, radio performances, and evening concerts require [her] full energy and focus.” Sharp WDT (CO Trial Ex. 6) at 4; 1/31/08 Tr. at 885 (Sharp).

225. In other situations, songwriters take jobs outside the music business when songwriting does not provide sufficient income. Mr. Bogard gave an example of a fellow songwriter who had won an Emmy award and two BMI performance awards, yet had to take a job selling handbags at a department store to make ends meet. Bogard WDT (CO Trial Ex. 2) at 8. According to Ms. Shaw, a songwriter friend of hers, also a BMI award winner, had taken a job working at the retail store Williams Sonoma to supplement his earnings from songwriting. *See* 1/30/08 Tr. at 827-29 (Shaw). Ms. Sharp testified as follows: “[J]ust last week a friend of mine had to pretend to be happy that she got accepted at Starbucks because now she has health insurance. She has . . . a major publishing deal, but still things are so tight and so scary that she had to take the gig at Starbucks.” 1/31/08 Tr. at 886-87 (Sharp). *See also* Paulus WDT (CO Trial Ex. 7) at 7 (“[C]urrently, many composers are forced to scrape by or rely on teaching or other jobs to support themselves.”); 1/31/08 Tr. at 914 (Paulus).

226. When songwriters are forced to split their time “between working at creating songs and working to pay the bills, the creative output suffers.” Bogard WDT (CO Trial Ex. 2) at 8. Ms. Sharp explained that “[i]t is extremely difficult, if not impossible, for songwriters to produce quality songs when they are focused on how to pay the bills. Being allowed to focus on songwriting alone provides great dividends in the quality of songs that are written.” Sharp WDT (CO Trial Ex. 6) at 7. Professor Murphy testified that an increase in the mechanical royalty rate would incentivize even part-time songwriters to write more songs. 5/15/08 Tr. at 6884-86 (K. Murphy). As he explained, economic theory predicts that the result of a rate increase would be not just more, but better songs. 5/19/08 Tr. at 6982-88 (K. Murphy).

227. No matter how much effort they exert, songwriters—unable to predict if or when then they will achieve success—are constantly beset by a variety of risks. As Mr. Galdston best summarized it: “in writing a song, there is a risk that it will not be recorded by an artist or licensed by a record label. Even if the song is recorded, it may not be released. If it is released, it may not be successful. If my songs are not successful, I may not have any income to provide for my family.” Galdston WDT (CO Trial Ex. 4) at 4-5; *see also* Shaw WDT (CO Trial Ex. 5) at 7 (stating that the financial rewards of songwriting are “far from guaranteed”); 1/28/08 Tr. at 214 (Carnes) (“[N]obody takes more risk than a songwriter . . . because . . . my chances of getting a song out to the market . . . are extremely small.”).

228. Not only is songwriting success unpredictable, but it often takes songwriters many years to begin to reap rewards from their creative endeavors. Ms. Sharp’s first song was not recorded until four years after she wrote it. Sharp WDT (CO Trial Ex. 6) at 2. It took Ms. Shaw eight years to get a music publishing deal, during which she time she repeatedly drove from New York to Nashville to pitch her songs. Shaw WDT (CO Trial Ex. 5) at 1-2; 1/30/08 Tr. at 818 (Shaw). Mr. Carnes explained that after he and his wife moved to Nashville to try to break into the music business, it took three years for them to write four songs, and even longer to get their songs recorded by other artists. Carnes WDT (CO Trial Ex. 1) at 3. Even when a songwriter’s composition is recorded and released, it can take a long time—as long as 18 months, and possibly longer, according to Ms. Sharp—for the first mechanical royalty check to arrive, and such delays are becoming more lengthy in the music industry. 1/31/08 Tr. at 870-71 (Sharp); *see also* 1/28/08 Tr. at 256 (Bogard).

229. Finally, as Mr. Carnes testified, “[s]ongwriters depend on mechanical royalties for their livelihood.” Carnes WDT (CO Trial Ex. 1) at 7; *see also* 1/28/08 Tr. at 201 (Carnes). Ms. Sharp explained that she was “dependent on mechanical royalties and advances from [her] publisher for the vast majority of [her] income.” Sharp WDT (CO Trial Ex. 6) at 2; *see also id.* at 5; 1/31/08 Tr. at 895-896 (Sharp). Likewise, Ms. Shaw testified that “[a] large portion of my income comes from mechanical royalties,” Shaw WDT (CO Trial Ex. 5) at 4; *see also* 1/30/08 Tr. at 829 (Shaw); and Mr. Galdston noted that he was “principally compensated” through mechanical royalty income. Galdston WDT (CO Trial Ex. 4) at 4.

C. Songwriters Face Significant Financial Challenges

230. Under the current mechanical royalty rate, it is difficult to make a living today as a songwriter. As songwriter witness after songwriter witness explained, remuneration for songwriting is low, even for the few hit songs that achieve significant commercial success.

1. The Financial Rewards of Songwriting Are Modest

231. The songwriters who testified in this proceeding all described the challenges of trying to support themselves and their families under the current mechanical royalty rate. Simply stated, “the vast majority of professional songwriters live a perilous existence.” Carnes WDT (CO Trial Ex. 1) at 3. As Mr. Bogard explained, “it is getting harder and harder for professional songwriters to build a career,” and “only the most successful songwriters are able to live on their royalties alone.” Bogard WDT (CO Trial Ex. 2) at 6. As described above, Ms. Sharp “cannot survive on songwriting income alone” and has “had to participate in many other aspects of the music business to stay financially afloat.” Sharp WDT (CO Trial Ex. 6) at 2. Similarly, Ms. Shaw

described living humbly, struggling financially and being “scared” that her income would go down “further than it is.” 1/30/08 Tr. at 815 (Shaw). These songwriters did not describe a glamorous lifestyle; rather, they spoke of struggling “to pay the mortgage, put the kids in school and have a car, [and] health insurance” 1/28/08 Tr. at 213-14 (Carnes).

232. Even for songwriters who write chart-topping hits, financial returns from mechanical royalties remain modest. As Mr. Bogard and Mr. Carnes demonstrated, a song that appears on an album that goes platinum (*i.e.*, sells a million copies)—an extremely rare occurrence—may generate only about \$20,000 in mechanical royalties for a songwriter after co-writers and publishers receive their shares. *See* Bogard WDT (CO Trial Ex. 2) at 9-10; *see also* Carnes WDT (CO Trial Ex. 1) at 5-6. Ms. Sharp, who wrote a song that sold over six million copies at a time when the mechanical royalty rate was 8 cents per song, received only \$12,000 after her co-writer and publisher took their shares, and after her publisher recouped the advances it had made to her in order to sustain her while she was less successful. *See* 1/31/08 Tr. at 879-80 (Sharp); Sharp WDT (CO Trial Ex. 6) at 5-6; *see also id.* at 6 (“even songs that sell millions of copies—while they earn the record companies millions of dollars—provide only modest returns to the songwriter”); Shaw WDT (CO Trial Ex. 5) at 4-5 (“The rewards from my biggest successes have not made me rich, for even having a song on a million-selling album won’t make me, as a songwriter, a millionaire.”); 1/28/08 Tr. at 213 (Carnes) (“it’s \$17,000 at the end of the day if you go platinum”).

233. The songwriters who testified before the Court explained that they feel lucky to have had hits, and that they never know when they will have another hit, which

makes it difficult to plan financially. Ms. Shaw described the “life of a songwriter is one of feast or famine,” which requires her family to live frugally. Shaw WDT (CO Trial Ex. 5) at 3; 1/30/08 Tr. at 825 (Shaw). Even when songwriters maintain a steady output of musical works, they are still likely to experience dramatic year to year income fluctuations. Galdston WDT (CO Trial Ex. 4) at 5; 1/30/08 Tr. at 792-94 (Galdston).

234. The fact that songwriters are facing financial difficulties today was corroborated by a witness for the RIAA, David Munns, who agreed that “in the current state of the industry, songwriters are suffering.” 2/26/08 Tr. at 4760 (Munns). In fact, Mr. Munns further agreed “that if the mechanical royalties are reduced, as the RIAA seeks, songwriters will suffer even more.” *Id.* at 4760-61.

2. Songwriters’ Mechanical Royalty Income Is Declining

235. As the songwriters testified, in today’s market, their already modest mechanical royalties are declining for a variety of reasons, including declining sales, due in part to piracy and consolidation in the music industry, and the increased use by record companies of controlled composition clauses.

(a) Piracy and Market Consolidation Harm Songwriters

236. Since 1999, the number of physical phonorecords sold in the United States has steadily declined. *See, e.g.*, Faxon WDT (CO Trial Ex. 3), CO Ex. 211; CO Trial Ex. 29 at 21. As Mr. Faxon explained, this decline represents lost “opportunities for songwriters to have their songs put into the marketplace.” 1/29/08 Tr. at 425 (Faxon).

237. The decline in sales of physical phonorecords is attributable in part to piracy. 1/30/08 Tr. at 657 (Faxon); Israelite WDT (CO Trial Ex. 11) at 9. As Professor Landes explained, the drop in sales due to piracy translates directly into a reduction in songwriters’ income and, in turn, a reduction in the incentive to write musical

compositions. Landes WDT (CO Trial Ex. 22) at 32; 2/11/08 Tr. at 2462 (Landes). Mr. Israelite similarly observed that the prevalence of piracy has “dramatically undercut the mechanical royalty stream, which, at bottom, is premised on a payment for every copy of a recording of a song that is distributed to the public.” Israelite WDT (CO Trial Ex. 11) at 10.

238. Songwriter witnesses in this proceeding similarly testified to the adverse impact that piracy has had on their income. Songwriters do not get paid for the millions of illegal downloads and pirated CDs of their music that are distributed in violation of the copyright laws. Bogard WDT (CO Trial Ex. 2) at 10. According to the songwriters, piracy has caused enormous losses for them, and it is one of the factors that has caused some songwriters to give up their careers in the music business. Carnes WDT (CO Trial Ex. 1) at 6; Shaw WDT (CO Trial Ex. 5) at 4; 1/30/08 Tr. at 793-94 (Galdston). In response, songwriters such as Mr. Galdston have joined the effort to fight piracy. Mr. Galdston testified that to help combat illegal downloading he has worked with organizations such as ASCAP, testified before the Intellectual Property Subcommittee of the House Judiciary Committee, spoken on radio and television, and written “op-eds” in newspapers. 1/30/08 Tr. at 797-98 (Galdston).

239. Witnesses for the RIAA and DiMA conceded that piracy has hurt songwriters and music publishers. *See, e.g.*, 2/20/08 Tr. at 3913 (Bassetti) (“Q: And I take it, you would also agree that the piracy has hurt songwriters as well, correct? A: Yes.”); 5/8/08 Tr. at 5393 (Slottje) (“Q: You agree that piracy also hurts the songwriters and the music publishers? A: Of course.”); Guerin-Calvert WDT (DiMA Trial Ex. 7) at

23 (piracy “represent[s] lost compensation to copyright owners and legitimate copyright users”).

240. In recent years, songwriters have also been hurt by corporate consolidation in the music industry (among record labels and retail stores) and among radio stations. Bogard WDT (CO Trial Ex. 2) at 8; Shaw WDT (CO Trial Ex. 5) at 4; 5/7/08 Tr. at 5167 (Santisi); 1/28/08 Tr. at 262 (Bogard). In addition, music publishers, including the majors, have scaled back their songwriter rosters. Bogard WDT (CO Trial Ex. 2) at 7; 1/28/08 Tr. at 260-61 (Bogard). These developments have led to fewer business opportunities for songwriters. *Id.*

(b) Controlled Composition Clauses Harm Songwriters

241. Controlled composition clauses are provisions in recording contracts between singer-songwriters (and producer-songwriters) and record companies. Many songwriter witnesses testified to the widespread use of controlled composition clauses by record companies to reduce mechanical royalties owed to singer-songwriters and their co-writers. For example, Ms. Shaw testified that “[t]he widespread use of controlled composition clauses . . . presents a major challenge for songwriters.” Shaw WDT (CO Trial Ex. 5) at 5. Mr. Galdston testified similarly: “[E]ven as the [mechanical] rate has increased, songwriters have come under what I can only characterize as a kind of assault to undercut that increasing rate, and that assault comes from the so-called three-quarter rate, the controlled composition rate.” 1/30/08 Tr. at 799-800 (Galdston); Galdston WDT (CO Trial Ex. 4) at 7. Messrs. Carnes and Bogard also testified to the common use of controlled composition clauses by the record companies. *See* Carnes WDT (CO Trial Ex. 1) at 5, 7; Bogard WDT (CO Trial Ex. 2) at 8.

242. Similarly, the RIAA's witnesses testified to the prevalence of controlled composition clauses. Michael Kushner, an executive with Atlantic Records, testified that controlled composition clauses are contained in "[v]irtually all" of the contracts between Atlantic and its artists. 2/14/08 Tr. at 3496 (Kushner). Ms. Finkelstein of Sony BMG testified that "[v]irtually all recording agreements include controlled composition clauses, and virtually all producer agreements contain controlled composition clauses." 2/14/08 Tr. at 3331 (A. Finkelstein). Indeed, nearly all Sony BMG releases are subject to a contract containing a controlled composition clause. *Id.* at 3379.

243. As Ms. Finkelstein conceded, these clauses all have the effect of reducing the mechanical royalty rate for the compositions that are released pursuant to them. 5/12/08 Tr. at 5727 (A. Finkelstein); *see also* 2/14/08 Tr. at 3496-97 (Kushner). Due to such clauses, the mechanical royalty rate that songwriters and publishers receive is often significantly lower than 9.1 cents per song. *See* Israelite WDT (CO Trial Ex. 11) at 10; Firth WDT (CO Trial Ex. 24) at 22-23; Robinson WDT (CO Trial Ex. 8) at 9. The rate is further reduced because songwriters frequently co-write with other songwriters or artists. *See* 1/28/08 Tr. at 206 (Carnes) (describing heightened impact of controlled composition clause due to songwriters sharing reduced rate with co-writers); 1/30/08 Tr. at 800 (Galdston) (typically getting 2.66 cents instead of 9.1 cents due to controlled composition clauses and co-writers). Ms. Shaw testified that "controlled composition clauses are frequently the first attempt" to negotiate songwriters down; as a result, she "hardly ever earn[s] the full statutory rate." Shaw WDT (CO Trial Ex. 5) at 5.

244. Controlled composition clauses reduce mechanical royalties in two primary ways. First, such clauses usually impose a percentage rate reduction from the

statutory mechanical royalty rate for songs written by the singer-songwriter. Landes WDT (CO Trial Ex. 22) at 30 n. 16; 1/29/08 Tr. at 426 (Faxon). The common practice is for the record companies to require a reduction to 75% of the statutory amount (that is, a 25% reduction). Carnes WDT (CO Trial Ex. 1) at 5; Shaw WDT (CO Trial Ex. 5) at 5. Second, these clauses impose a cap on the number of songs (typically, 10 songs) for which the record company will pay mechanical royalties, which, in tandem with the 25% reduction described above, further ratchets down the mechanical royalties that singer-songwriters receive. Landes WDT (CO Trial Ex. 22) at 30 n. 16; 1/31/08 Tr. at 942 (Robinson); 1/29/08 Tr. at 426 (Faxon).

245. Two examples of artist contracts containing such provisions are found in the trial record, and they corroborate the testimony described above. The standard form artist contract used by Atlantic Recording Corporation, Warner Brothers Records Inc., and Rhino Entertainment Company (which are all part of the Warner Music Group) includes a section titled [REDACTED] CO Trial Ex. 56 at RIAA 45275. [REDACTED]

[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED] *Id.* [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED] *Id.* at RIAA 45275-76. [REDACTED]
“ [REDACTED]

[REDACTED]
[REDACTED]
[REDACTED] *Id.*

246. [REDACTED]. CO
Trial Ex. 297 at 33. [REDACTED]

[REDACTED] *Id.* [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED] *Id.* [REDACTED]

[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED] *Id.* at 35.

247. The effect of controlled composition clauses is not limited to singer-
songwriters. [REDACTED]
[REDACTED]
[REDACTED]

CO Trial Ex. 56 at RIAA 45275; CO Trial Ex. 297 at 46.

248. Ms. Sharp explained the practical consequences of such terms. She testified that her current recording deal “contains a controlled composition clause, which forces me to accept a 25% decrease in the statutory rate. Even worse than having to accept the 25% cut, was having to call my co-writers and ask them to accept the 25% cut as well. Thus, although the controlled composition clause is a hardship for me, it is a particular hardship for my co-writers, who did not themselves sign the contract or receive any advance under the contract.” Sharp WDT (CO Trial Ex. 6) at 6. *See also* 1/28/08 Tr. at 206 (Carnes); 1/29/08 Tr. at 427 (Faxon) (“there’s something more pernicious about these agreements in that they force all other participants in writing on that album into the same box.”). Because of the operation of a controlled composition clause, even a “pure” songwriter—one who is not a performer on an album—may be told by an artist that unless he accepts a reduced rate, his song will not appear on an album. 1/28/08 Tr. at 211-12 (Carnes). If a potential co-writer refuses to accept a reduced rate, and the artist still wants to work with that co-writer, the artist’s only other alternative is to pay the co-writer additional royalties out of his or her own pocket—an unappealing and unlikely outcome. *Id.* at 211; 1/29/08 Tr. at 427 (Faxon).

249. Songwriters feel compelled to accept these reduced rates. When asked why she accepted controlled compositions clauses, Ms. Sharp answered: “I have accepted it because it was made very clear to me that if I didn’t accept it that I wasn’t going to have a record deal.” 1/31/08 Tr. at 886 (Sharp). Ms. Shaw testified that “[e]fforts to fight back against the use of such clauses will only hurt [her] career, because [her] songs will get pulled from new albums,” and that she feels like she lacks bargaining power in comparison to the record labels. Shaw WDT (CO Trial Ex. 5) at 5; 1/30/08 Tr.

at 829-30 (Shaw). Mr. Carnes and Mr. Bogard testified to the same point: they lack any real alternative to accepting controlled rates. *See* 1/28/08 Tr. at 207, 210-11, 221-22 (Carnes); 1/28/08 Tr. at 256-57 (Bogard). *See also* 2/5/08 Tr. at 1448 (Israelite) (“I think the situation for songwriters is such where, as many have testified, the choice that they’re given is not a true market choice; that it’s really an imposition upon them.”).

250. As Mr. Faxon explained, four record companies account for approximately 85% of the market, making it difficult for any songwriter to avoid what has become standard practice. Faxon WRT (CO Trial Ex. 375) at 11. *See also* 1/31/08 Tr. at 1012 (Robinson) (“[S]ince almost every record company, every major record company seems to engage in that practice, the choice is, I become an artist or I don’t become an artist.”). Moreover, the singer-songwriter’s chief concern when negotiating his or her contract is “the total amount he or she will be paid,” not whether every distinct contractual provision is optimal. Faxon WRT (CO Trial Ex. 375) at 12; *see also* 5/14/08 Tr. at 6412-13 (Faxon) (singer-songwriters have a number of objectives in reaching agreements with record labels, including getting a record released, the level of the royalty rate, the amount of the advance and the amount of the label’s marketing commitment).

(c) The Record Companies Aggressively Apply Controlled Composition Clauses

251. The evidence presented to the Court in this proceeding revealed that the record companies aggressively apply controlled composition clauses. *See* 5/12/08 Tr. at 5731-42 (A. Finkelstein). In fact, record evidence shows that at least one record company, Sony BMG, is applying a provision of controlled composition clauses in its post-1995 recording contracts to the sale of DPDs. *See id.*

252. Section 115 provides that the statutory rate shall apply to digital phonorecords deliveries “in lieu of any contrary royalty rates specified in a contract pursuant to which a recording artist who is the author of a nondramatic musical work grants a license under that person’s exclusive rights in the musical work . . . or commits another person to grant a license in that musical work . . . to a person desiring to fix in a tangible medium of expression a sound recording embodying the musical work.” 17 U.S.C. § 115(c)(3)(E)(i). However, “a contract entered into on or before June 22, 1995” is exempt from this proscription. *Id.* § 115(c)(3)(E)(ii)(I). Thus, controlled composition clauses in artist contracts that postdate June 22, 1995 are not to apply to sales of digital phonorecords.

253. On cross-examination during the rebuttal phase of the proceeding, when Ms. Finkelstein was asked if she understood “that for tracks released pursuant to artist agreements that postdate June 22, 1995, Sony BMG is prohibited from paying reduced rates on DPDs notwithstanding controlled composition clauses,” she testified, “[c]orrect.” 5/12/08 Tr. at 5731 (A. Finkelstein); *see also id.* at 5741-42. Nevertheless, Ms. Finkelstein subsequently admitted that even for artist contracts that postdate June 22, 1995, Sony BMG is in fact applying the “Net Sales” provision referenced in its controlled composition clause to reduce the mechanical royalties paid for the sale of DPDs. *Id.* at 5734-35; 5740.

254. As described above, Sony BMG’s template artist contract contains a controlled composition clause that specifies that the company is obliged to pay mechanical royalties only on “Net Sales.” 5/12/08 Tr. at 5732-33 (A. Finkelstein). Although the term “Net Sales” has one definition that generally applies throughout the

contract, it is subject to a different definition when it is used in the controlled composition clause. *Id.* at 5733-34. Specifically, “Net Sales” is defined as [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]—the controlled composition clause—[REDACTED]
[REDACTED]
[REDACTED] CO Trial Ex. 297 at 49. In other words, pursuant to its controlled composition clause, Sony BMG’s form artist agreement calls for the company to pay mechanical royalties on at most 85% of gross sales; there is a “Net Sales” discount of at least 15%. 5/12/08 Tr. at 5734-36 (A. Finkelstein).

255. Ms. Finkelstein testified unambiguously that Sony BMG applies the reduction to 85% of gross sales, which is specified for use exclusively in its controlled composition clause, to reduce payments for the sales of DPDs written under artist contracts that postdate 1995. *Id.* at 5734-35, 5740. For such DPDs, Sony BMG pays the statutory rate, but on only “85 percent of units actually sold.” *Id.* at 5740. As discussed in the Copyright Owners Proposed Conclusions of Law, this practice appears to contravene the plain language of Section 115(c)(3)(E).

256. This practice also appears to contradict Ms. Finkelstein’s prior testimony in this proceeding. During the direct phase of the trial, in response to questioning from the Court, Ms. Finkelstein claimed that “one of our biggest concerns is that post-‘95 contracts do not allow for controlled composition clauses on digital releases” and that “[w]e’re losing the benefits of those controlled composition clauses.” 2/14/08 Tr. at 3422 (A. Finkelstein). She further testified: “The physical album format, we still are licensing

under controlled composition clauses. But a good percentage of the digital we're not able to take advantage of it." *Id.* at 3423; *see also* 5/12/08 Tr. at 5736 (colloquy between the Court and A. Finkelstein).

**(d) The Music Publishers' Financial Information
Corroborates the Decline in Mechanical Royalties**

257. The weight of the evidence demonstrates that mechanical royalty revenues earned by music publishers have generally been declining since 2000, notwithstanding the increases in the mechanical royalty rate that occurred in 2002, 2004 and 2006. *See* 37 C.F.R. § 255.3. This evidence is largely consistent across the music publishing industry.

258. The lion's share of mechanical royalty revenue is collected by HFA. HFA's financial statements for 2001 and 2006 show a significant decline in mechanical licensing revenue. *See* CO Trial Exs. 12A, 12B. In 2001, HFA's mechanical royalty collections were \$426 million, exclusive of royalties collected through audits. CO Trial Ex. 12A at 6. In 2006, HFA's mechanical royalty collections were \$349 million exclusive of audits, a decline of almost \$100 million. CO Trial Ex. 12B at 13; *see also* 2/5/08 Tr. at 1500-1504 (Israelite) (discussing gross receipts, which are largely comprised of mechanical royalties, from the same years). Adjusted for inflation (that is, converted into real dollars), the drop would be even steeper.

259. EMI MP, which was the largest music publisher during this period, has also seen a decline in mechanical revenues. From a starting point in FY 2000/2001, in which mechanical revenues were [REDACTED], mechanical revenues have dropped to [REDACTED] in FY 2006/2007, [REDACTED]. *See* Santisi WRT (RIAA Trial Ex. 78) at 49; CO Trial Ex. 375, Ex. A; 5/7/08 Tr. at 5214 (Santisi). Again, Mr. Faxon reported that "[f]or the first 11 months of FY 07/08, [EMI MP's] mechanical royalty income

declined to [REDACTED] from [REDACTED] during the comparable period in FY 06/07, a reduction of approximately [REDACTED].” Faxon WRT (CO Trial Ex. 375) at 2-3, Ex. A. This decline occurred notwithstanding the fact that EMI MP increased its market share over the period “by improving its success at identifying successful songwriters, increasing its investment in these songwriters, and through acquisitions of rights to additional musical compositions.” *Id.* at 2. And the decline reported by EMI MP in nominal dollars would be even greater if converted into real dollars to take into account inflation over the period since 2000.

260. During the years 2000 through 2006, Famous Music Publishing experienced a decline in mechanical royalties from \$16.6 million to \$12.6 million. *See* CO Trial Ex. 9; RIAA Trial Ex. 15. As its then-CEO Mr. Robinson observed, this approximately 25% decline occurred notwithstanding several increases in the mechanical royalty rate. 1/31/08 Tr. at 1102 (Robinson).

261. Warner/Chappell also experienced a significant decline on a global basis between 2000 and 2006. Santisi WRT (RIAA Trial Ex. 78) at 52. The company had global mechanical royalty revenues of [REDACTED] in 2000. *Id.* By 2006, mechanical revenue fell to [REDACTED] in 2006. *Id.* RIAA expert witness Terri Santisi acknowledged that although she had not seen U.S.-only numbers for Warner/Chappell, she knew from her consulting work for the company that there had been a similar decline in U.S. mechanical royalty revenues over the same period. 5/7/08 Tr. at 5222-23 (Santisi).

262. Results from Sony/ATV show that mechanical royalty revenues dropped slightly from [REDACTED] in 2000/2001 to [REDACTED] in 2005/2006. Santisi WRT

(RIAA Trial Ex. 78) at 50. And the Sony/ATV drop would be greater if converted from nominal into real dollars.

263. The only company to report an increase in mechanical royalties over the period was UMPG. Computed in nominal as opposed to real dollars, Universal showed modest growth in mechanical royalty earnings, from ██████████ in 2000 to ██████2 ██████ in 2005. *Id.* at 51.

264. This evidence squarely contradicts the testimony of Ms. Santisi who claimed “there has been no steep decline in mechanical royalties in recent years.” Santisi WRT (RIAA Trial Ex. 78) at 23; *see also* 5/7/08 Tr. at 5219 (Santisi). To begin with, there can be no dispute that there has been a decline, whether it is characterized as “steep” or not. Moreover, Ms. Santisi’s analysis made no attempt to adjust in any way for acquisitions of catalog, which would have served to mask the rate of decline in mechanical revenue. 5/7/08 Tr. at 5216 (Santisi). Nor did Ms. Santisi attempt to measure the market share over time of any of the publishers. *Id.* at 5225-26. And, finally, Ms. Santisi failed to consider the effect of inflation, which must be taken into account in any measurement of differences in revenue over time. *Id.* at 5215 (Santisi) (“I did not inflation-adjust” financial information from music publishers).

(e) Professor Landes Corroborates the Decline in Mechanical Royalties

265. The songwriters’ testimony concerning the decline in mechanical royalties is further corroborated by Professor Landes. To assess trends in songwriter income, Professor Landes conducted a study of nearly 10,000 songwriters. Landes WRT (CO Trial Ex. 406) at 8. His data revealed that songwriter income has been declining and that

a substantial number of songwriters depend heavily on income from mechanical royalties.
Id.

266. Professor Landes analyzed both mechanical royalty income and total royalty income earned during the period 2000 to 2006 by songwriters whose compositions were administered by UMPG. *Id.* He examined two groups of songwriters: (1) a “full songwriter sample,” which contained 9,438 songwriters whose songs had reported royalty earnings in every year from 2000 to 2006; and (2) a “songwriter subgroup,” a group of 4,164 songwriters that remained from the full songwriter sample after excluding the 95 songwriters in the top one percent of all royalty earners (songwriters who earned on average more than \$██████████ per year) and the 5,179 songwriters who on average earned less than \$██████████ per year. *See id.* at 8-9. Professor Landes analyzed both the average and median royalty earnings of these sets of songwriters. *See id.* at 8-10. In order to assess the trend in real, inflation-adjusted dollars, Professor Landes converted all nominal dollar figures into 2007 dollars using the “Consumer Price Index-Urban Wage Earners and Clerical Workers” (U.S. Bureau of Labor Statistics Series CWSR0000SA0). *See id.* at 6 n. 5.

267. Prior to Professor Landes’s testimony before the Court during the rebuttal phase of the proceeding, the RIAA filed a motion *in limine* to preclude admission of his songwriter study on the grounds that it was unreliable and failed to meet the standards for admission of expert testimony under *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993). *See* 5/19/08 Tr. at 7112-7206 (Landes); *see also* RIAA’s Motion in Limine to Exclude Portions of the Written Rebuttal Testimony of William Landes, Docket No. 2006-3 CRB DPRA (May 14, 2008).

268. The Copyright Owners opposed the motion, explaining that although the RIAA had identified issues concerning Professor Landes's methodology for the songwriter study that supposedly rendered it unreliable, the opposite was true: correction of the issues identified by the RIAA did not change in any material way any of the results in the songwriter survey, or alter any of Professor Landes's conclusions. Copyright Owners' Opposition to RIAA's Motion in Limine to Exclude Portions of the Written Rebuttal Testimony of William Landes, Docket No. 2006-3 CRB DPRA (May 19, 2008), at 2. Those corrections were initially included in Professor Landes's Written Rebuttal Testimony. 5/19/08 Tr. at 7123-39 (Landes).

269. The Court denied the RIAA's *Daubert* motion, ruling that the expertise necessary for admission of the original testimony had been established. *Id.* at 7201 (Sledge, J.). The Court also declined to admit Professor Landes's Written Rebuttal Testimony with the corrections provided, on the grounds that the RIAA had been surprised by them and not had sufficient time to analyze them. *Id.* Nevertheless, Professor Landes's rebuttal report, including the original songwriter study, was subsequently admitted into evidence with the corrections removed. *Id.* at 7203-06. Professor Landes explained on the witness stand that he stood by all of the conclusions he drew from the original study. *Id.* at 7203-04.

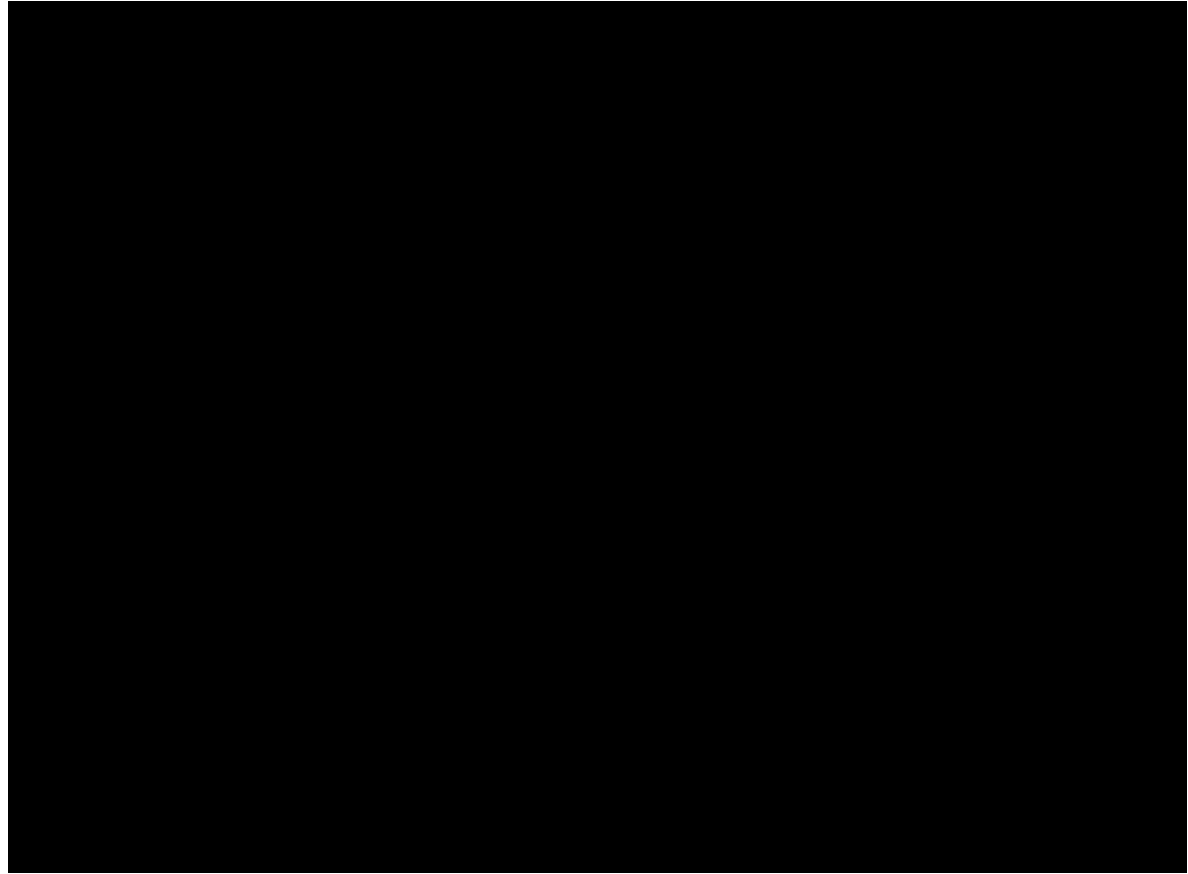
270. Professor Landes further testified that the issues that the RIAA identified had a "[n]egligible" impact on his original work, *id.* at 7124, and that with respect to his analysis of songwriter income over time, the principal effects of correcting the testimony would have been (a) to increase the sample sizes in his study to include songwriters who were mostly low-earners and (b) as a result, to *decrease* the absolute values of mean and

median songwriter income, *see id.* at 7124-31. The trends in income in his original testimony were unaffected. *See id.* Of the songwriters included in his original, admitted study, Professor Landes explained that their earnings would “increase slightly” if the RIAA’s concerns were addressed, *id.* at 7125, and that this effect would only occur for the data in the years 2005 and 2006, *id.* at 7127.

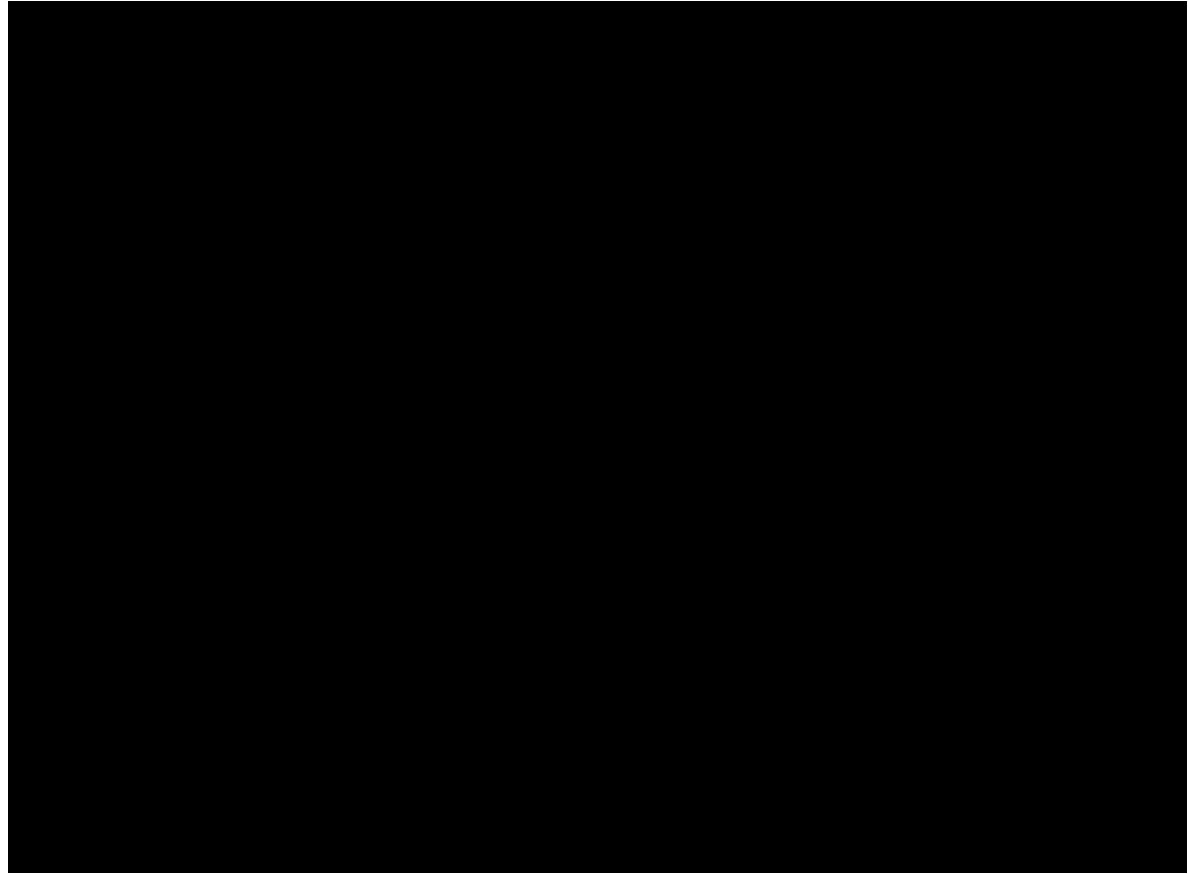
271. Professor Landes’s study remains the only empirical evidence in the record on the impact of the mechanical royalty rate on songwriters. His specific conclusions are described below.

(i) Mechanical Income Is Falling

272. Professor Landes’s study found a decline in mechanical royalty income earned by UMPG songwriters over the period 2000 to 2006. Landes WRT (CO Trial Ex. 406) at 8-9; 5/19/08 Tr. at 7214 (Landes). This was true for the songwriters in both the full songwriter sample and the songwriter subgroup, and in both average and median annual royalty income. *Id.* In the full songwriter sample, average annual mechanical income fell from roughly ██████ in 2000 to approximately ██████ in 2006. *See id.* at Figure 2a.



273. In the songwriter subgroup, average annual mechanical income fell from about ██████ in 2000 to approximately ██████ in 2006. *See id.* at Figure 3a; 5/19/08 Tr. at 7217-18 (Landes).

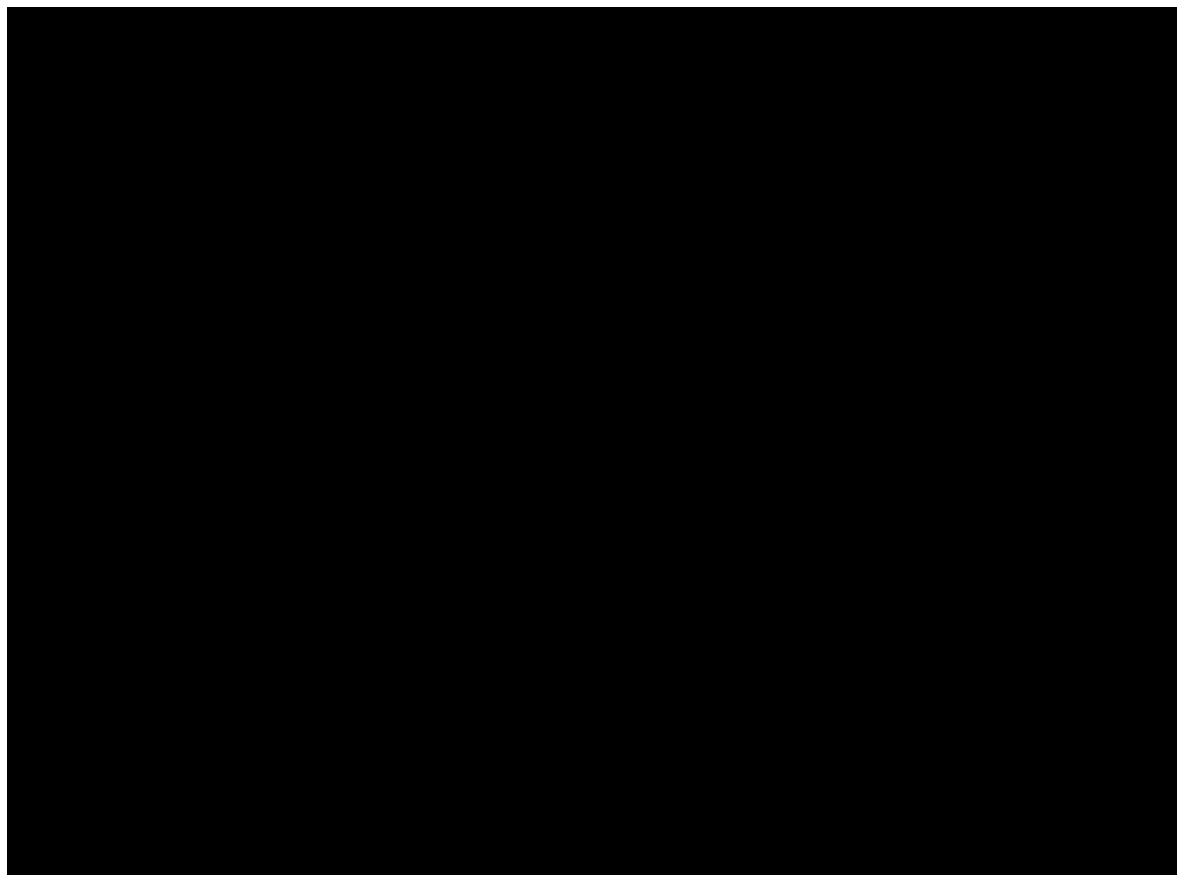


274. Median annual mechanical royalty income also fell for songwriters in both the full songwriter sample and the songwriter subgroup. *See id.* at Figure 2b, Figure 3b. In the songwriter subgroup, the decline in median annual mechanical royalty income was over \$500 from 2000 to 2006. *See id.* at Figure 3b.

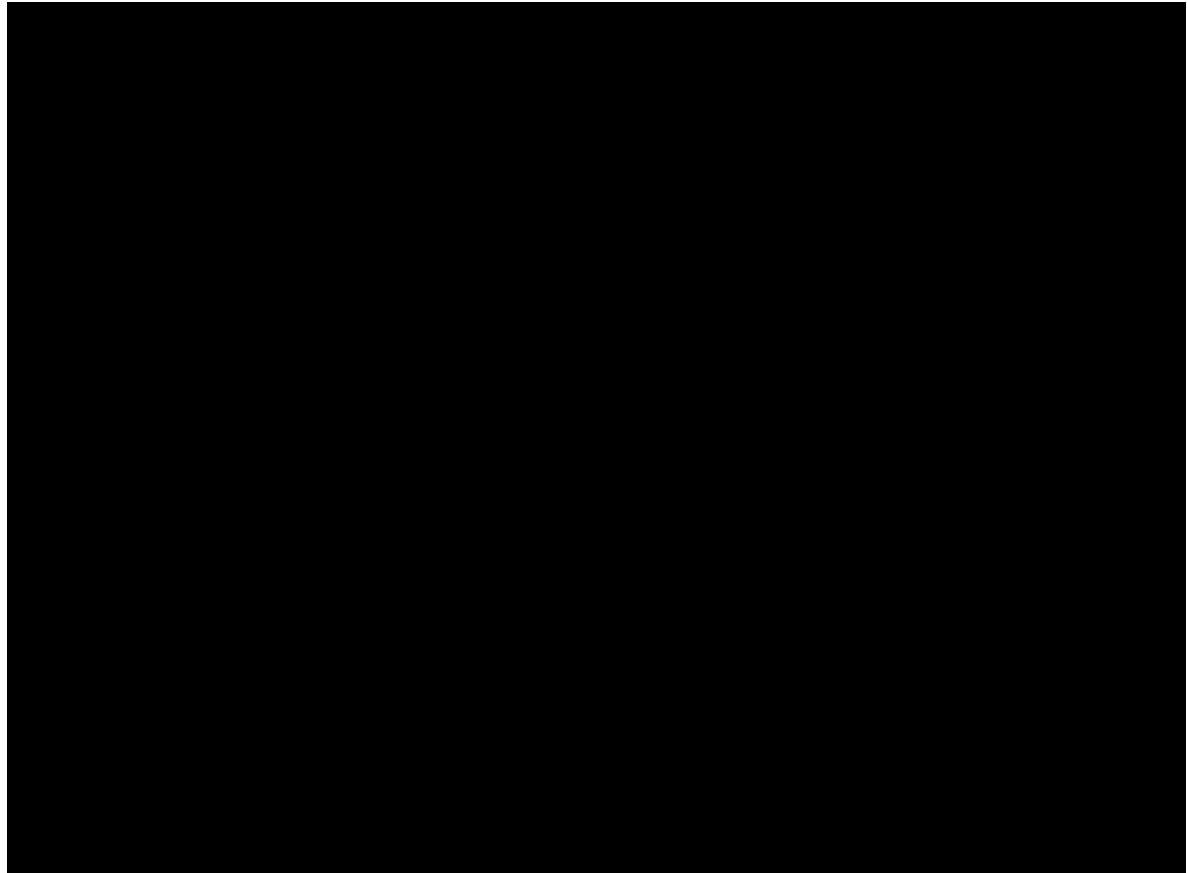
(ii) Total Income Is Falling

275. The pattern of results for trends in total royalty income demonstrated that a reduction in mechanical royalty income would likely reduce the earnings of many songwriters. *Landes WRT (CO Trial Ex. 406) at 8.* In the full songwriter sample of UMPG’s songwriters, average total royalty income in 2006 was roughly equal to average total royalty income in 2000, although in many of the intervening years, total royalty

income was lower than it was in 2000. *Id.* at 9-10, Figure 4a; see also 5/19/08 Tr. at 7220-21 (Landes).



276. In the songwriter subgroup, average total royalty income was slightly lower in 2006 than in 2000, while again, in the intervening years, total royalty income was noticeably lower than it was in 2000. *See* Landes WRT (CO Trial Ex. 406) at 9-10, Figure 5a.

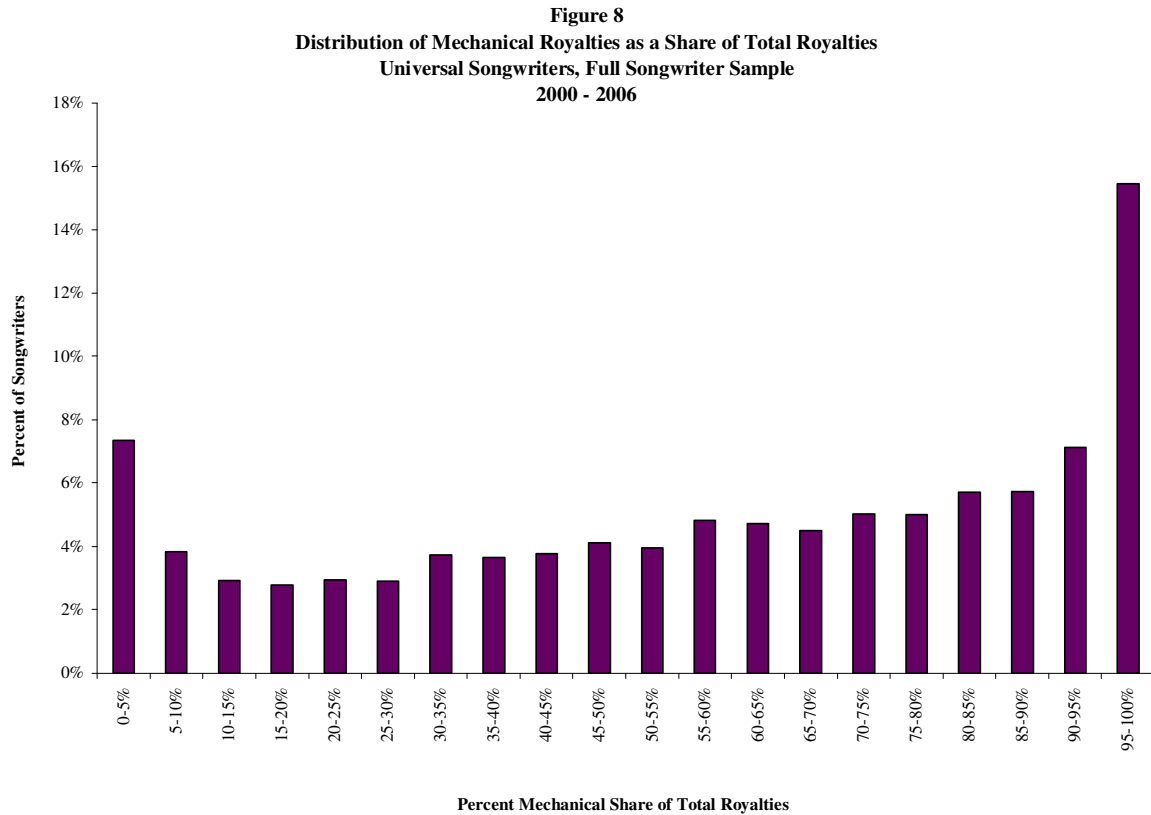


277. For both groups, median total royalty income was “substantially lower” in 2006 than in 2000. *Id.* at 10; *see also id.* at Figure 4b, Figure 5b. In the songwriter subgroup, the decline in median total royalty income from 2000 to 2006 was approximately \$1,000. *See id.* at Figure b; *see also* 5/19/08 Tr. at 7222 (Landes).

(iii) Songwriters Depend Heavily on Mechanical Royalties

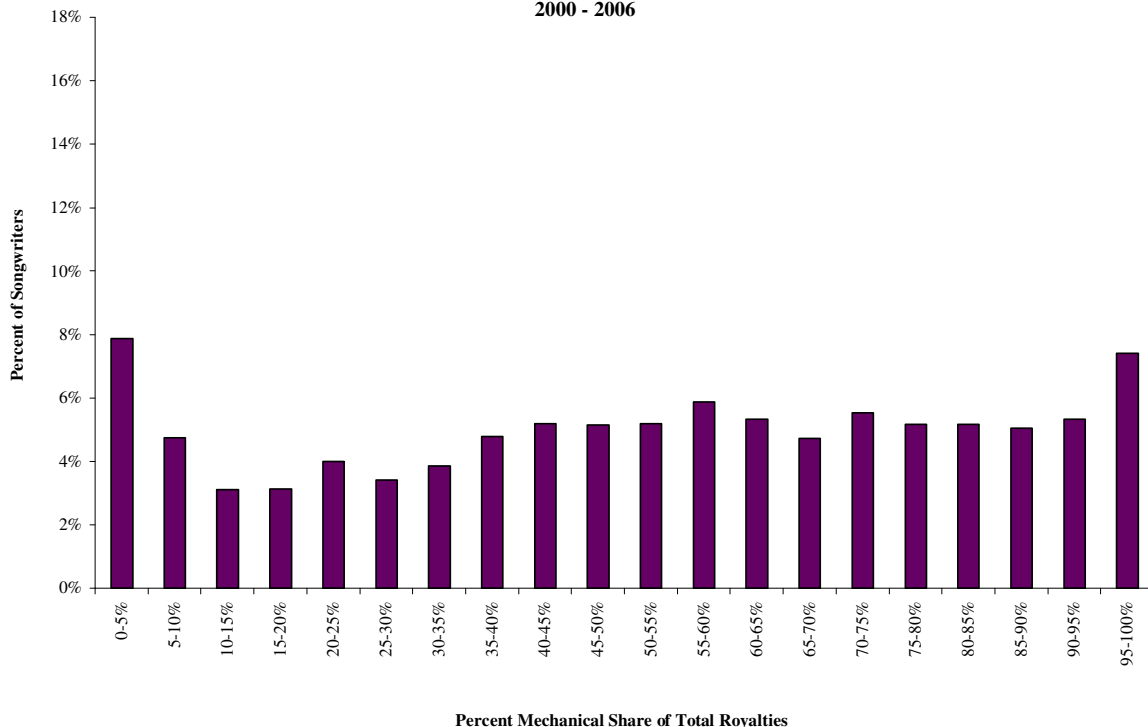
278. Professor Landes’s study of UMPG songwriters also corroborates songwriters’ testimony that they depend heavily on income from mechanical royalties. Landes WRT (CO Trial Ex. 406) at 11. In the full songwriter sample, nearly two-thirds of songwriters received 50% or more of their total royalty income (over the entire period 2000 to 2006) from mechanical royalties, and nearly 40% of songwriters received 75% or

more of their total royalty income from mechanical royalties. *Id.*; see also 5/19/08 Tr. at 7225-26 (Landes). Figure 8 from Professor Landes’s Written Rebuttal Testimony illustrates this trend:



279. The experience of the songwriter subgroup was similar: approximately 55% received 50% or more of their total royalty income from mechanical royalties, and roughly 30% received 75% or more of their total royalty income from mechanical royalties. *Id.* Figure 9 from Professor Landes’s Written Rebuttal Testimony illustrates this trend:

Figure 9
Distribution of Mechanical Royalties as a Share of Total Royalties
Universal Songwriters, Songwriter Subgroup
2000 - 2006



(f) Professor Teece Corroborates the Decline in Mechanical Royalties

280. While there are reasons to question the accuracy of the mechanical royalty revenue numbers in Exhibit 28 of RIAA witness Professor Teece’s report, his own data corroborates the testimony of the songwriters with respect to the decline in mechanical royalties. In his written report, Professor Teece presented a table (Exhibit 28) of actual and estimated mechanical royalty revenues for U.S. music publishers. Teece WDT (RIAA Trial Ex. 64) at 59. As Professor Teece admitted, the table includes actual data only through 2001, and estimates for 2002-2005. *Id.*; 2/19/08 Tr. at 3730 (Teece). Although a note to Exhibit 28 stated, “[i]f I receive revised data from the music publishers in discovery, I will revisit this analysis,” Professor Teece did not, in fact,

amend his report based on actual financial data produced by the publishers in discovery. Teece WDT (RIAA Trial Ex. 64) at 59; 2/19/08 Tr. at 3730-33 (Teece).

281. Even though it was not updated based on actual financial results, Exhibit 28 nevertheless shows that music publishers' mechanical royalty revenues were at an all-time high of \$691 million in 2000, fell to \$542 million in 2003, and although they rose to \$673 million in 2005, were still below the 2000 level in nominal dollars. Teece WDT (RIAA Trial Ex. 64) at 59. On an inflation-adjusted, "real dollar" basis, the decline is even greater. *See* 5/7/08 Tr. at 5214-15 (Santisi) (nominal dollars, as opposed to real dollars, are not adjusted for inflation).

3. Songwriters Need an Increase in the Mechanical Royalty Rate

282. Numerous songwriters testified that, in light of the risks they take, they believe that they are not fairly compensated under the current mechanical royalty rate, and that the mechanical royalty rate should be increased by the CRJs. As Mr. Galdston testified, "I believe that an increase in the mechanical rate is warranted. . . . [T]he current mechanical rate does not provide a fair return on the creative or business investment made by the songwriter." Galdston WDT (CO Trial Ex. 4) at 8. Ms. Shaw said the same thing: "[B]ecause of the structure of the compulsory license system, and with rates at their current levels, I am not being fairly compensated for the efforts I make and risks I take to continue to be a professional songwriter." Shaw WDT (CO Trial Ex. 5) at 7.

283. The songwriters further testified that an increased mechanical royalty rate likely will increase not only the number of songwriters, but also the number of musical compositions produced. According to Mr. Bogard, "[i]ncreasing the statutory rate will allow songwriters and music publishers to enlarge the talent pool and thus increase the number of songs that are recorded and released to the public." Bogard WDT (CO Trial

Ex. 2) at 10. Mr. Carnes testified that “an increase in the statutory rate will allow songwriters and music publishers to increase the pool of available songs and maximize the number of creative works.” Carnes WDT (CO Trial Ex. 1) at 7; *see also* 1/28/08 Tr. at 232 (Carnes) (stating that if the mechanical rate is increased, more people will write songs, “because there would be more career opportunities. As long as there are career opportunities, you are going to get more songs written.”).

284. Conversely, as the songwriters testified, if the rate is not increased, or if it is decreased, current and potential songwriters are likely to be driven away from the business. Mr. Galdston explained that “if the mechanical rate is not increased, many songwriters will be forced to abandon their careers and many others—including the promising members of the next generation—will choose never to pursue their songwriting dreams in the first place.” Galdston WDT (CO Trial Ex. 4) at 8; *see also* 1/30/08 Tr. at 801-02 (Galdston) (“And I think the net result, if there isn’t a rate increase, is that fewer people will go into songwriting [and] many fewer people will go into pure songwriting . . .”). Similarly, Ms. Sharp testified that “[i]f the mechanical rate is not increased, music publishers will be more reluctant to take on new songwriters. This will have a chilling effect on the discovery and support of songwriting talent, and ultimately the pool of songs created—so vital to American music culture—will be diminished.” Sharp WDT (CO Trial Ex. 6) at 7.

285. Increasing the mechanical royalty rate will also improve the quality of songwriters’ compositions. According to Mr. Carnes, if there is such an increase, “[b]etter songs will be released to the public.” 1/28/08 Tr. at 233 (Carnes). Ms. Sharp explained that even an increase of a penny in the mechanical royalty rate would help her

“to make artistically driven choices rather than financially driven choices. The importance of this cannot be overstated.” Sharp WDT (CO Trial Ex. 6) at 7.

286. The Presidents of both the SGA and the NSAI testified based on their experience in the industry that the number of American songwriters—at least those who are professional songwriters—is falling. 1/28/08 Tr. at 232 (Carnes); Bogard WDT (CO Trial Ex. 2) at 10. According to Mr. Bogard: “Over the past decade, the number of professional songwriters has declined substantially, and Nashville has been particularly hard hit.” Bogard WDT (CO Trial Ex. 2) at 6; *see also* 1/28/08 Tr. at 258 (“[W]e have about half of the professional songwriters we did even five years ago. The community is basically decimated.”). Based on his experience “as an active member of the songwriting community,” Mr. Galdston testified, “I’ve seen a good number of my contemporaries drop out of songwriting and turn their love of music into other walks of life within the business, and some drop out entirely. But what’s more painful is all of the young people I meet in my advocacy work or in my teaching and the young artists I’m working with who wonder whether they’re going to be able to make a living doing this.” 1/30/08 Tr. at 801 (Galdston). *See also* Shaw WDT (CO Trial Ex. 5) at 8 (under the current mechanical royalty rates, potential writers are being driven away from the business).

V. The Music Publishing Industry

A. Overview

287. Music publishers serve as representatives and advocates for the interests of songwriters, working to ensure that their creative achievements are properly rewarded. Faxon WDT (CO Trial Ex. 3) at 4. To those ends, among other functions, music publishers help songwriters create and exploit their works by assisting them in the

creative process, promoting their works to record companies and artists, and licensing and administering their works.

288. The music publishing industry is composed of major publishers and independent publishers. The “major publishers” are affiliated with large media conglomerates and the major record labels. Today, the major music publishers are: EMI MP, which is part of the EMI Group; UMPG, the publishing arm of the Universal Music Group, which acquired BMG Music Publishing (“BMG MP”) in 2007; Sony/ATV Music Publishing (“Sony/ATV”), a joint venture between Sony Corporation and Michael Jackson; and Warner/Chappell, the publishing division of Warner Music Group. 2/4/08 Tr. at 1380 (Israelite).

289. The “independent publishers,” such as Peermusic, are not affiliated with the major record companies. Peer WDT (CO Trial Ex. 13) at 2; 1/31/08 Tr. at 926 (Robinson). Famous was an independent publisher until 2007, when it was acquired by Sony/ATV. 1/31/08 Tr. at 926 (Robinson). There are thousands of small music publishers currently in operation. *See* Pedecine WRT (CO Trial Ex. 394) at 1 (noting that HFA represents approximately 35,000 music publishers).

B. Music Publishers Play Critical Roles

290. Throughout this proceeding, the RIAA has claimed that music publishers are simply passive recipients of mechanical royalties who do little to earn their share or assist in the creative process. *See, e.g.*, Kushner WDT (RIAA Trial Ex. 62) at 2 (“[p]ublishers do not make significant contributions to this process [of creating successful musical works and sound recordings] apart from authorizing use of their songs.”); Munns WDT (RIAA Trial Ex. 76) at 16 (“[a]part from the unique case of country music in Nashville, most publishers no longer actively develop writers’ careers but instead merely

make advances and collect and administer royalties.”). *See, e.g.*, Faxon WDT (CO Trial Ex. 3) at 4-12; Firth WDT (CO Trial Ex. 24) at 6-21; Robinson WDT (CO Trial Ex. 8) at 10; Peer WDT (CO Trial Ex. 13) at 4.

291. As mountains of evidence presented during this proceeding established, however, that is far from the case. In fact, as witness after witness—music publisher, songwriter and record company executive—testified, music publishers make critical contributions to the creation of songs and to the success of the overall music industry. *See, e.g.*, Faxon WDT (CO Trial Ex. 3) at 4-12; Robinson WDT (CO Trial Ex. 8) at 10-21; Israelite WDT (CO Trial Ex. 11) at 4-7; Peer WDT (CO Trial Ex. 13) at 4-18; Firth WDT (CO Trial Ex. 24) at 6-20; 2/14/08 Tr. at 3466-69 (Kushner); 2/20/08 Tr. at 3909 (Bassetti). Songwriter Victoria Shaw, perhaps, put it best: “I think I’m always a good songwriter, but I will say every time I’m with a publisher, I seem to get more cuts that bring me in more money.” 1/30/08 Tr. at 837-38 (Shaw).

292. During the direct phase of the proceeding, the Copyright Owners presented testimony from four music publishers—Roger Faxon from EMI MP, Nicholas Firth from BMG MP, Ralph Peer from Peermusic, and Irwin Robinson from Famous—each a current or former CEO of a significant music publishing company. Each described in detail the significant role of music publishers and explained why an increase in mechanical royalties is necessary to ensure the continued vitality of American music. *See generally*, Faxon WDT (CO Trial Ex. 3); Peer WDT (CO Trial Ex. 13); Robinson WDT (CO Trial Ex. 8); Firth WDT (CO Trial Ex. 24). David Israelite, the President and CEO of NMPA, provided similar testimony. *See* Israelite WDT (CO Trial Ex. 11) at 5-7.

293. In addition, a number of songwriters testifying on behalf of the Copyright Owners corroborated this testimony. Both Ms. Shaw and Maia Sharp, for example, described the important role music publishers have played, and continue to play, in developing and assisting their creative work and sustaining them financially. *See Shaw WDT (CO Trial Ex. 5) at 2, 5-7; Sharp WDT (CO Trial Ex. 6) at 2-5.*

294. As each of these witnesses explained, and as more fully described below, music publishers, among other functions: (1) discover and nurture talent; (2) provide financial support to songwriters; (3) provide creative support to songwriters; (4) promote songwriters and further the exploitation of their musical compositions; and (5) and administer mechanical licenses, collect mechanical royalties, and provide other important ministerial functions on behalf of songwriters. *See generally, Faxon WDT (CO Trial Ex. 3) at 5-12; 1/29/08 Tr. at 374-76, 387-85, 389-94, 401-10 (Faxon); Firth WDT (CO Trial Ex. 24) at 6; Robinson WDT (CO Trial Ex. 8) at 10; 1/31/08 Tr. at 950-55, 957-68 (Robinson); Peer WDT (CO Trial Ex. 13) at 4; Israelite WDT (CO Trial Ex. 11) at 5-7.* Significantly, “[t]he basic functions of the music publisher are essentially the same in both the on-line and off-line worlds.” *Faxon WDT (CO Trial Ex. 3) at 19; 1/29/08 Tr. at 411 (Faxon).*

1. Publishers Discover Songwriters

295. As Mr. Robinson testified, music publishers’ “relationships with songwriters often begin at the earliest stages of their careers, long before they have produced successful songs or otherwise developed names for themselves in the industry.” *Robinson WDT (CO Trial Ex. 8) at 15-16; see also Peer WDT (CO Trial Ex. 13) at 5; 2/15/08 Tr. at 1578-79 (Peer).* Although record company executives repeatedly claimed sole credit for the discovery of music talent, new songwriters are, in fact, frequently

discovered by music publishers. Nor is it true, as many record company witnesses contended, that music publishers only sign songwriters once they have recording agreements. In 2005 alone, for example, out of the 42 new songwriters BMG MP discovered and signed, 27 of them had not yet released a commercial record. Firth WDT (CO Trial Ex. 24) at 7.

296. Such discoveries are made by a music publisher's A&R Department, which forms the "cornerstone" of efforts to identify and build a relationship with previously "undiscovered" songwriters. *See* Faxon WDT (CO Trial Ex. 3) at 6. As Mr. Faxon testified, music publishers are constantly challenged to discover talented new songwriters and will "use many means, and expend considerable resources, to make such discoveries." *Id.*

297. To that end, music publishers employ A&R personnel who are specifically devoted to talent scouting. Before its acquisition by Sony/ATV, Famous Music had 8 employees who participated in talent-scouting activities, working with a budget in excess of \$10 million each year, a significant amount for what was a "boutique operation." Robinson WDT (CO Trial Ex. 8) at 16, *see also* 1/31/08 Tr. at 953-54 (Robinson). And prior to its acquisition by UMPG, BMG MP had an A&R staff with 18 full-time employees in the United States alone, and total A&R investments each year of approximately 4% of BMG's total revenues. Firth WDT (CO Trial Ex. 24) at 7; 2/12/08 Tr. at 2672-74 (Firth). [REDACTED]

[REDACTED] Faxon WDT (CO Trial Ex. 3) at 6; *see also* 1/29/08 Tr. at 383-84 (Faxon); Faxon WDT (CO Trial Ex. 3), Ex. 201).

298. A&R staff members use a variety of means to find new talent. Among other activities, they attend showcases and other live performances, listen to demonstration (“demo”) records sent by songwriters directly, and investigate recommendations from sources inside the music industry including other songwriters, club owners, entertainment lawyers and artist managers. *See* Faxon WDT (CO Trial Ex. 3) at 5; Peer WDT (CO Trial Ex. 13) at 4; 2/5/08 Tr. at 1566-68 (Peer); Firth WDT (CO Trial Ex. 24) at 7; 1/31/08 Tr. at 953 (Robinson).

299. More recently, A&R representatives for the music publishers have also begun to scour the Internet, particularly social-networking websites such as MySpace.com, as well as artists’ blogs, online radio stations, and music television websites, all in the search for new discoveries. Peer WDT (CO Trial Ex. 13) at 3-4; 2/5/08 Tr. at 1567-68 (Peer); Faxon WDT (CO Trial Ex. 3) at 5; 1/29/08 Tr. at 376 (Faxon). Indeed, today there are A&R employees at music publishers who are devoted to searching the Internet for new talent full-time. Faxon WDT (CO Trial Ex. 3) at 5.

300. As Mr. Faxon testified, in practice, the “search for talent is a very hit or miss proposition and very few of the leads pursued by our A&R employees bear fruit.” *Id.* at 6. A telling example is the “success rate” of Jake Ottman, one of EMI MP’s Creative Directors. Mr. Ottman routinely speaks to 50 to 60 industry contacts, who recommend roughly 200 new bands or songwriters in total each week. Out of the thousands of bands and songwriters considered over the course of a year, in 2005, EMI MP found only three new bands worth signing and 63 new songwriters. *Id.*; *see also* 1/29/08 Tr. at 385 (Faxon). Mr. Firth testified to similar efforts and results made by the A&R department at BMG MP. *See* Firth WDT (CO Trial Ex. 24) at 7-8.

301. But as many music publishers also testified, some of their extensive efforts have met with resounding success, leading to the discovery of a large number of the industry's most talented songwriters and performers. As Mr. Faxon testified with respect to one notable example, EMI MP discovered and signed James Blunt, who at the time had not had any dealings with record companies although he had already written a number of promising songs. Faxon WDT (CO Trial Ex. 3) at 14. EMI MP signed Mr. Blunt in November 2002. According to Mr. Faxon, "it was impossible to get [Blunt] a record deal" at that time. 1/29/08 Tr. at 380-381 (Faxon). Instead, EMI MP provided substantial creative, financial and promotional support for 18 months until Mr. Blunt, thanks to introductions from EMI MP representatives, finally secured a recording contract with Custard Records, a joint venture with Warner Music's Atlantic label. Faxon WDT (CO Trial Ex. 3) at 14-15. The advances paid to Mr. Blunt, independent of other expenses incurred on his behalf, totaled [REDACTED] before his record was even released. *Id.* at 15. According to evidence introduced by RIAA witness Terri Santisi, Mr. Blunt's first album, *Back to Bedlam*, was the best selling album in both the U.K. and U.S. when it was released. 5/7/08 Tr. at 5232-33 (Santisi). The album ultimately generated approximately [REDACTED] in profits for Atlantic Records; profits the record label would not have had were it not for the efforts of EMI MP. CO Trial Ex. 214; 5/7/08 Tr. at 5234-36 (Santisi). Mr. Firth shared similar stories about recent BMG discoveries Jason Michael Carroll, Yellowcard and Moxie. Firth WDT (CO Trial Ex. 24) at 8-9; *see also* Robinson WDT (CO Trial Ex. 8) at 16-17 (discussing the discovery of promising Nashville songwriter Lance Miller).

302. In addition to discovering previously unknown talent, music publishers often develop songwriters who have been passed over or dropped by record labels. Mr. Peer presented testimony on Peermusic's significant role in the breakthrough of Buddy Holly, for example. Peer WDT (CO Trial Ex. 13) at 5-6). Mr. Holly had initially signed a contract with Decca Records in Nashville, but Decca refused to release his work and ultimately opted not to renew Mr. Holly's contract. *Id.* at 5. Once Mr. Holly recorded a new demo version of "That'll Be the Day," now one of his most famous songs, he continued to pitch it to a wide range of record companies, but found no success. *Id.* Mr. Holly signed a songwriter agreement with Peermusic, where executives recognized his potential and forwarded the song to contacts at Coral Records, which ultimately released it. *Id.* at 6; *see also* 2/5/08 Tr. at 1589-93 (Peer).

303. Mr. Robinson provided a more recent example, describing the relationship between Famous and Linda Perry, a singer-songwriter who signed a songwriter deal with Famous in 1993. Robinson WDT (CO Trial Ex. 8) at 17. Even though Ms. Perry had a hit song, "What's Up," with the band 4 Non Blondes, she was eventually dropped by her record label. *Id.* Famous continued to work with Ms. Perry, nurturing her career over the next five years, listening to her material, providing her with constructive criticism, and reintroducing her to record labels as a producer and songwriter for other artists. *Id.* Ms. Perry has subsequently become a successful producer-songwriter, earning both a Grammy nomination and an ASCAP Songwriter of the Year Award. *Id.*; *see also* 1/31/08 Tr. at 958-960 (Robinson); *see also* Firth WDT (CO Trial Ex. 24) at 9 (providing examples of songwriters helped by BMG MP during periods in which they were effectively ignored by record companies). Ms. Sharp recounted a similar story,

describing how Major Bob Music, an important Nashville music publisher, supported her creatively and financially after she was dropped by record label I.R.S. in 1999. Sharp WDT (CO Trial Ex. 6) at 3.

2. Publishers Provide Financial Support to Songwriters

304. Once songwriters are discovered by music publishers, they are signed to the music publisher through a songwriter agreement. *See* Faxon WDT (CO Trial Ex. 3) at 7; Robinson WDT (CO Trial Ex. 8) at 18; 1/31/08 Tr. at 950-951 (Robinson); Peer WDT (CO Trial Ex. 13) at 6; 2/5/08 Tr. at 1570 (Peer); Firth WDT (CO Trial Ex. 24) at 9-10. Typically, these agreements have specified terms, often for one to three years, at the end of which the music publisher has the option to extend for an additional term if desired. *See* Faxon WDT (CO Trial Ex. 3) at 7; Peer WDT (CO Trial Ex. 13) at 6; 2/5/08 Tr. at 1571-1573 (Peer); 1/31/08 Tr. at 951 (Robinson). Agreements may also be structured around the delivery of a certain number of songs or an album by the songwriter. Faxon WDT (CO Trial Ex. 3) at 7; 2/5/08 Tr. at 15731 (Peer); 1/31/08 Tr. at 951 (Robinson).

305. Pursuant to songwriter agreements, almost without exception, music publishers pay advances to songwriters. Mr. Robinson testified that he “did not think there [was] ever a deal that didn’t call for payment of advances.” 1/31/08 Tr. at 964 (Robinson); *see also* 2/5/08 Tr. at 1588 (Peer). These advances can be recouped against future earnings. *See* Faxon WDT (CO Trial Ex. 3) at 7; Robinson WDT (CO Trial Ex. 8) at 18; Peer WDT (CO Trial Ex. 13) at 7; 2/5/08 Tr. at 1575 (Peer); Firth (CO Trial Ex. 24) at 9-10. Under these agreements “once (and if) the songwriter begins to earn mechanical royalties, those royalties are paid to us [the music publisher] until the advance is paid back.” Peer WDT (CO Trial Ex. 13) at 7. Advances to songwriters are typically

provided on a non-recourse basis, meaning that songwriters are not obligated to pay back the publishers if they are not successful. 1/29/08 Tr. at 387 (Faxon); *see also* Robinson WDT (CO Trial Ex. 8) at 19.

306. Advances provided to songwriters can take many forms. According to Mr. Firth, advances are typically paid either as monthly draws or split between a lump sum on signing with the rest paid on a monthly basis. Firth WDT (CO Trial Ex. 24) at 10; *see also* 1/31/08 Tr. at 950-51 (Robinson). For producer-songwriters or singer-songwriters, approximately half of the advance is usually paid when the agreement is signed and the remainder is paid as songs or albums are commercially released. Firth WDT (CO Trial Ex. 24) at 10. The structure of advance payments may also depend on the songwriter's genre and location. As Ms. Sharp testified, advance payments in Nashville tend to take the form of weekly or monthly payments, while in LA, publishers are more likely to pay advances as a lump sum. 1/31/08 Tr. at 877 (Sharp). Some music publishers may provide songwriters with non-monetary advances in the form of apartment rentals, third-party marketing or transportation for touring, or "relationship advances" when a songwriter with whom a publisher has had a longstanding relationship needs additional support during a period of hardship. Peer WDT (CO trial Ex. 13) at 8; 2/5/08 Tr. at 1579-81, 1586-1587 (Peer).

307. The amounts paid as advances can also vary greatly. According to Mr. Faxon, "[t]he size of the advance depends on a number of factors, including the potential of the songwriter, whether the songwriter already has had successful songs, whether there is a 'buzz' in the industry about the songwriter and whether the songwriter has a record deal." Faxon WDT (CO Trial Ex. 3) at 7. Competition for a particular songwriter may

also lead to higher advances. *Id.*; *see also* Firth WDT (CO Trial Ex. 24) at 11. Mr. Robinson testified that, as with the form of payment, the genre in which a songwriter works may also impact the size of the advance he or she receives, with pop and urban music songwriters tending to receive somewhat higher advances than most country music songwriters. Robinson WDT (CO Trial Ex. 8) at 18; *see also* Peer WDT (CO Trial Ex. 13) at 7-8.

308. Overall, the amount spent on songwriter advances each year is substantial. Mr. Robinson testified that country writers signed with Famous typically receive advances of approximately \$40,000-\$50,000, with some receiving advances that are \$100,000 or more. Robinson WDT (CO Trial Ex. 8) at 18; 1/31/08 Tr. at 964-65 (Robinson). Pop and urban music songwriters, many of whom also act as producers or singers, receive advances measured in the hundreds of thousands of dollars, or, in some cases, ranging from \$1 million-\$2 million. *Id.* Advances paid by Peermusic commonly measure in the hundreds of thousands of dollars, exceeding \$500,000 in some cases. Peer WDT (CO Trial Ex. 13) at 7; 2/5/08 Tr. at 1573-74 (Peer). In 2005, the average advance paid by BMG to new songwriters was approximately \$186,000. Although Mr. Firth testified that this figure was slightly higher than usual because of a few relatively large advances paid to more well-known songwriters, he also testified that the median new songwriter advance that year was \$75,000. Firth WDT (CO Trial Ex. 24) at 10.

309. Significantly, music publishers continue to provide such critical financial support to songwriters even though most songwriter agreements now guarantee music publishers a smaller share of any royalties that are earned after advances are recouped. *See* Faxon WDT (CO Trial Ex. 3 at 7; Robinson WDT (CO Trial Ex. 8) at 19; 1/31/08 Tr.

Peer WDT (CO Trial Ex. 13) at 6-7; 2/5/08 Tr. at 1650 (Peer); Firth WDT (CO Trial Ex. 24) at 11. In the past, it was common for royalties to be shared 50:50 between songwriters and music publishers. Peer WDT (CO Trial Ex. 13) at 6; 1/31/08 Tr. at 971 (Robinson). The royalty split between songwriters and music publishers, however, over the past 15-20 years, has shifted substantially and a 75:25 split in favor of the songwriters has become increasingly prevalent. Peer WDT (CO Trial Ex. 13) at 6; *see also* Robinson WDT (CO Trial Ex. 8) at 19; 1/31/08 Tr. at 971 (Robinson); 2/5/08 Tr. at 1650 (Peer); 1/29/08 Tr. at 388-89 (Faxon). In some cases, particularly popular artists or songwriters may demand, and receive, as much as 80-90% of the royalties earned on their works, if not more. Robinson WDT (CO Trial Ex. 8) at 19; Faxon WDT (CO Trial Ex. 3) at 7; 1/29/08 Tr. at 502-02 (Faxon); Peer WDT (CO Trial Ex. 13) at 6; 2/5/08 Tr. at 1650 (Peer).

310. Numerous witnesses highlighted the significance of music publisher advances to the chances of songwriter success. As each of the testifying music publishers explained, advances provide critical “seed money” that allows songwriters to focus their talent, time and effort on creating new songs and building a career. *See* Faxon WDT (CO Trial Ex. 3 at 7-8; Robinson WDT (CO Trial Ex. 8) at 18; Peer WDT (CO Trial Ex. 13) at 6-7; 2/5/08 Tr. at 1574 (Peer); Firth WDT (CO Trial Ex. 24) at 11. Simply put, “[i]t is not an overstatement to say that, in most cases, these advances keep songwriters fed and clothed, and without them many aspiring songwriters would drop out of the business.” Firth WDT (CO Trial Ex. 24) at 10.

311. Mr. Faxon agreed that advance “payments are necessary to finance the day-to-day requirements of the songwriter’s career, including for professional bills,

management commissions, equipment costs, to hire vans for performances, pay taxes and for general living expenses. Advances enable songwriters to survive financially so they can concentrate on developing their talent and the musical compositions that are the fundamental source of value for the music industry.” Faxon WDT (CO Trial Ex. 3) at 7. Largely because of such advances, songwriters are able to devote their time to songwriting “instead of to odd jobs that do nothing to hone their music skills,” to the benefit of their creative output. Robinson WDT (CO Trial Ex. 8) at 18.

312. The songwriter witnesses who testified before the Court emphasized the importance of advances to their careers. As Mr. Bogard observed, a songwriter’s creative output suffers if his time is spent away from writing songs. Bogard WDT (CO Trial Ex. 2) at 8. Mr. Bogard credits his publishing partners, and the advances he has received from them, with providing the flexible financial support needed to pursue a career in songwriting without having to split his time between songwriting and other jobs. Bogard WDT (CO Trial Ex. 2) at 11. Ms. Sharp similarly testified that she was better able to focus on writing songs and making music because of the advances she received. Sharp WDT (CO Trial Ex. 6) at 5. Ms Shaw explained that the financial support received through her music publishing deals alleviated stress and made her “more productive.” 1/30/08 at 832 (Shaw). Advances provided “some help financially, so I could breathe, so I could calm down, so I could write better.” *Id.* at 831; *see also* 1/28/08 Tr. at 202 (Carnes).

313. Although music publishers recognize that advances to songwriters are “essential to enabling both new and established songwriters to develop their talent and create new songs,” Faxon WDT (CO Trial Ex. 3) at 7, the payment of such advances

constitutes a major and risky expense for music publishers. See also Landes WRT (CO Trial Ex. 406) at 13-14 (setting forth recent advance totals for UMPG, EMI MP, and Warner/Chappell). In 2005, EMI MP's advance payments totaled \$54 million dollars, or approximately 24% of the \$229 million earned in revenues. 1/29/08 Tr. at 390 (Faxon); *see also* Faxon WDT (CO Trial Ex. 3), Ex. 202. In comparison, overhead costs totaled only [REDACTED]. Faxon WDT (CO Trial Ex. 3) at 8. In 2006, EMI MP paid \$43.7 million in advances, which totaled roughly 18.5% of the \$235.8 million earned in revenues. Faxon WDT (CO Trial Ex. 3), Ex. 204. In 2007, advances for EMI MP increased to approximately \$70 million. 1/29/08 Tr. at 391 (Faxon).

314. Mr. Firth testified, “[c]umulatively, we spent almost \$8 million on advances to new songwriters in 2005 and our total spending on advances, to both new and previously-signed songwriters, was almost \$30 million. This represented over 20% of BMG MP's total revenue.” Firth WDT (CO Trial Ex. 24) at 10. Mr. Peer testified similarly that advances “constituted [REDACTED] of [Peer's] total operating cost [from 2003-2007].” Peer WDT (CO Trial Ex. 13) at 8.

315. Providing songwriters—most of whom will not ultimately be financially successful—with advances of this magnitude is a risky proposition for music publishers. *See* Robinson (WDT CO Trial Ex. 8) at 18-19; Firth WDT (CO Trial Ex. 24) at 11-12. The “success rate” for even the most talented songwriters is very low. Mr. Firth observed that only 10% of songwriters are successful. 2/12/08 Tr. at 2666 (Firth). Mr. Robinson estimated that the rate of success was even lower, falling somewhere between 2% and 5%. Robinson WDT (CO Trial Ex. 8) at 19; 1/31/08 Tr. at 967 (Robinson); *see also* 2/5/08 Tr. at 1714015 (Peer). Although music publishers are willing to provide advances

318. Once a songwriter is signed, members of a music publisher's creative department begin to work with the new songwriter to develop the writer's skills and songs. Often, a songwriter is paired up with the creative professional who first discovered the writer or who sponsored that songwriter's signing. Robinson WDT (CO Trial Ex. 8) at 19; Firth WDT (CO Trial Ex. 24) at 12. Regardless of the structure of the relationship or of a music publisher's creative team, these departments serve as sounding boards for a writer's new works. As Mr. Firth summarized, "[o]ur creative professionals listen to, constructively criticize and edit our songwriters' songs before they are demoed and subsequently marketed to record labels and the film and television community," a process known as pitching or song-plugging. Firth WDT (CO Trial Ex. 24) at 12. Mr. Peer provided similar testimony about the efforts of Peermusic's creative team, and elaborated on the additional support Peermusic provides to classical music composers, who require greater investments of time and resources than many pop or country songwriters. Peer WDT (CO Trial Ex. 13) at 9-10. The collaboration between songwriter and music publisher not only enhances the songwriter's creative vision and output, but allows publishers to make their own creative contribution to new musical works. Israelite WDT (CO Trial Ex. 11) at 5.

319. In many instances, this assistance is provided in a music publisher's own in-house studio, built and maintained at significant expense. Famous has "a fully-equipped recording studio in which our songwriters and creative professionals sample new artists and songs, exchange ideas and experiment with new melodies" in its Nashville office. Robinson WDT (CO Trial Ex. 8) at 20. Peermusic has studios in a number of its offices, including Los Angeles, Nashville and Miami for similar purposes,

each of which cost more than \$100,000 to build and requires more than \$30,000 in annual maintenance. Peer WDT (CO Trial Ex. 13) at 9; *see also* Faxon WDT (CO Trial Ex. 3) at 9.

320. Music publishers also contribute to the creative process by suggesting and arranging for collaborations among songwriters, producers, recording artists and labels. *See* Robinson WDT (CO Trial Ex. 8) at 13; 1/31/08 Tr. at 951-52, 960-62 (Robinson); Peer WDT (CO Trial Ex. 13) at 10-11; 2/5/08 Tr. at 1594 (Peer); Firth WDT (CO Trial Ex. 24) at 13-14; 1/29/08 Tr. at 370 (Faxon); Israelite WDT (CO Trial Ex. 11) at 5. Indeed, Mr. Firth considers songwriter collaboration to be an art in its own right. Prior to its acquisition by UMP, BMG MP had two employees dedicated solely to facilitating the co-writing opportunities that generated 90% of BMG MP's new songs. Firth WDT (CO Trial Ex. 24) at 13. BMG MP also regularly hosted events that brought together songwriters and recording artists, such as breakfasts and luncheons where new artists perform for songwriters. *Id.* BMG MP's Nashville office also hosted "Song Camps" where BMG MP songwriters from around the world were given "the opportunity to meet each other and generate ideas for new, jointly-written compositions." *Id.* at 13-14; *see also* 2/12/08 Tr. at 2662-64 (Firth).

321. Music publishers are often responsible for the collaborations that lead to successful recordings. BMG MP's recent Song Camps have, for example, led to popular hits by country artists Kenny Chesney and Brooks and Dunn. Firth WDT (CO Trial Ex. 24) at 13-14; *see also* 2/12/08 Tr. at 2662-2664. Mr. Firth also testified to a collaboration BMG MP arranged between producer Toxic and artist Keyshia Cole that resulted in a hit single from her album *The Way It Is*, which sold over 1.4 million copies. *Id.* at 13. *See*

also Peer WDT (CO Trial Ex. 13) at 10-11 (discussing Bachá, a tropical music group born out of Peermusic's Miami office); Robinson WDT (CO Trial Ex. 8) at 13 (listing a number of recent popular works co-written by Famous songwriters).

322. Again, a number of the testifying songwriters confirmed how important this creative support has been to them and their careers. Mr. Bogard, who has worked with a number of music publishers over the course of his career, explained that his publishing relationships “have given me the opportunities to develop as a songwriter and helped me learn to write the best possible songs I can. They have provided creative encouragement as well as industry contacts that I could never have made on my own or, in my opinion, through A&R executives at record labels. They helped me to learn to differentiate between a good song and a great one that is likely to be recorded, released and mean something to millions of people.” Bogard WDT (CO Trial Ex. 2) at 10.

323. Ms. Sharp, as another example, credited music publishers with facilitating her creative development throughout her career. Ms. Sharp recounted how Miles Copeland, the head of I.R.S. Music and her first music publisher, sent her to week-long songwriting retreats in France. At these retreats, Ms. Sharp met, collaborated, and developed lasting relationships with other songwriters, including Carole King, Stewart Copeland, the GoGos and the Bangles. Sharp WDT (CO Trial Ex. 6) at 5; 1/31/08 Tr. at 874 (Sharp). Bob Doyle, the head of Major Bob Music and Ms. Sharp's second music publisher, played a similar role, introducing her to many different artists in Nashville. Sharp WDT (CO Trial Ex. 6) at 5. As Ms. Sharp testified, “thanks to his introductions, I have many solid relationships with artists to whom I can pitch songs in Nashville as well.” *Id.*

4. Publishers Promote Songwriters' Works

324. The efforts of music publishers on behalf of their songwriters are far from over once new songs have been completed. In fact, one of the primary roles a music publisher can play is as a promoter of those songs to artists, managers, producers, A&R representatives at record labels, or others who may want to license the songs. *See* Faxon WDT (CO Trial Ex. 3) at 9-10; Robinson WDT (CO Trial Ex. 8) at 10-13; Peer WDT (CO Trial Ex. 13) at 11-15; Firth WDT (CO Trial Ex. 24) at 14-17. These efforts are ultimately responsible for any song's commercial success and take on many forms. As Mr. Robinson testified, "[songwriters] are really good at creating [the song], but . . . need structure in the way the exploitation of their music is handled, and that is why they come to a publisher." 1/31/08 Tr. at 969 (Robinson).

325. First, once a songwriter has finished writing a musical composition, music publishers participate in the creation of the demo recordings that will be promoted to artists, record producers and record company executives. *See* Robinson WDT (CO Trial Ex. 8) at 20; 1/31/08 Tr. at 951 (Robinson); Peer WDT (CO Trial Ex. 13) at 13-14; 2/5/08 Tr. at 1581 (Peer). Demo recordings are the customary way to present a polished product to the music industry, and are a critical way of making a first impression. In this regard, music publishers' experience in the industry and familiarity with the market provide crucial guidance. As Mr. Israelite summarized, music publishers can "shape demos in ways that they know are likely to attract artists and the labels, thereby increasing the chances that the song will come to life off of the page." Israelite WDT (CO Trial Ex. 11) at 6. Music publishers recognize the importance of a well-executed demo recording and, accordingly, "invest thousands of dollars and many hours of time creating demo recordings" each year. Peer WDT (CO Trial Ex. 13) at 13.

326. The rosters of many music publishing companies now include an increasing number of singer-songwriters or producer-songwriters. *See* Firth WDT (CO Trial Ex. 24) at 15. Accordingly, in many cases, demo recordings are used to promote the singer or producer as much as they are used to promote the song. At BMG MP, for example, the promotional team helps such multi-talented individuals find record company contracts that allow them to exploit all of their skills. *Id.* Mr. Faxon provided similar testimony about EMI MP's efforts to market singer-songwriters to record companies, as did Mr. Peer about efforts made at Peermusic. Faxon WDT (CO Trial Ex. 3) at 9; Peer WDT (CO Trial Ex. 13) at 12.

327. Music publishers have always been known as song-pluggers, a role they continue to fill today through their efforts to identify recording artists to record their writers' compositions. As Mr. Firth explained, music publishers are still "heavily involved in soliciting both recording artists and record producers to perform and produce [their] songwriters' songs, as well as songwriters to compose works for recording artists who need writing assistance." Firth WDT (CO Trial Ex. 24) at 15; *see also* Robinson WDT (CO Trial Ex. 8) at 11; Peer WDT (CO Trial Ex. 13) at 12, 2/5/08 Tr. at 1605-08 (Peer). In a typical week, BMG MP's song-pluggers, for example, would "attend between 20 and 25 meetings to pitch songs to record label A&R executives, producers, artist and managers." Firth WDT (CO Trial Ex. 24) at 14-15."

328. Mr. Robinson presented similar testimony, explaining that Famous, as part of its pitching efforts, "would ask or set up sessions where the writers themselves would go to a potential user of a song and play on a guitar or piano the songs we [were] interested in having them use." 1/31/08 Tr. at 952 (Robinson). Mr. Robinson also

testified that music publishers on occasion would assist record companies with the exploitation or promotion of their artists' works." *Id.* at 991. Ms. Shaw testified to the importance of these efforts by explaining how Randy Hart, a song-plugger at publisher Gary Morris, was primarily responsible for securing the recording and release of two of her earliest hit songs, "Too Busy Being in Love" and "I Love the Way You Love Me," thanks to his tireless efforts to promote them to record labels. Shaw WDT (CO Trial Ex. 5) at 6; 1/30/08 Tr. at 820-21.

329. Music publishers also actively seek out licensing opportunities for their songwriters' compositions beyond release on new albums. In many cases, music publishers attempt to maximize the value of their writers' works by seeking out synchronization deals to place those works in films, television shows and commercials. 2/5/08 Tr. at 1608-09 (Peer). Mr. Faxon described how EMI MP helped place songs in movies including *The Last King of Scotland*, *Touching the Void* and *The Fast and the Furious: Tokyo Drift*, as well as television shows from *CSI* to *Grey's Anatomy* and *Scrubs*. Faxon WDT (CO Trial Ex. 3) at 10; *see also* 1/29/08 Tr. at 404 (Faxon). Mr. Robinson presented an equally long list of recent synchronization licenses for musical works in the Famous catalog. *See* Robinson WDT (CO Trial Ex. 8) at 11-12; *see also* 1/31/08 Tr. at 962-63 (Robinson).

330. Beyond providing another stream of licensing income, synchronization opportunities have proved to be critical in augmenting the success of already popular works, and in attracting record labels or the listening public to previously neglected songwriters or singer-songwriters. For example, as Mr. Peer testified, successful synchronization placements of music by the band The Shys helped catch the attention of

the band's own record label, Sire/WB. According to Mr. Peer, until the group's music appeared in two television shows, "Sire/WB was making little effort to encourage the group's development, but after the synch licenses were in place, Sire/WB began helping with marketing initiatives and made several tour investments." Peer WDT (CO Trial Ex. 13) at 15; 2/5/08 Tr. at 1609-10 (Peer).

331. Mr. Firth recounted how BMG MP raised the profile of the now enormously popular band Maroon 5 by placing one of the band's songs in a television commercial and another in three popular television shows. Firth WDT (CO Trial Ex. 24) at 16. BMG MP's efforts, and the opportunities they created, directly increased Maroon 5's exposure and helped the band to sell more than 10 million copies of its debut album. *Id.*; *see also* Peer WDT (CO Trial Ex. 13) at 15 (discussing how synchronization opportunities can also lead to a resurgence of interest in older songs that "may have slipped from the spotlight," such as the six songs in Peermusic's catalog that were used in the movie *O Brother, Where Art Thou?* as well as on its Grammy-award winning soundtrack).

332. The financial investments made by music publishers to these ends are significant. For example, at the end of its fiscal year in 2006, EMI MP had spent ██████ ██████ dollars on development and promotional activities. In 2007, EMI MP planned to spend about the same amount ██████ on development and promotion. Faxon WDT (CO Trial Ex. 3) at 10; *see also id.*, Ex. 205. Mr. Peer also testified, in reference to Peermusic's combined creative and promotional efforts, that approximately 40% of annual costs are dedicated to such direct investments in the company's songwriters. Peer WDT (CO Trial Ex. 13) at 15.

5. Publishers Provide Administrative Support to Songwriters

333. Music publishers have also assumed the responsibility for administering licenses and collecting royalties on behalf of songwriters, as well as other critical ministerial functions. *See generally* Faxon WDT (CO Trial Ex. 3) at 11-12; 1/29/08 Tr. at 407-10 (Faxon); Robinson WDT (CO Trial Ex. 8) at 20-21); 1/31/08 Tr. at 952 (Robinson); Peer WDT (CO Trial Ex. 13) at 16-18; 2/5/08 Tr. at 1612-15 (Peer); Firth WDT (CO Trial Ex. 24) at 17-20. As Mr. Peer testified, “administration is a very important part of what a music publisher contributes to songwriter's development and well-being. It is far from trivial.” 2/5/08 Tr. at 1612 (Peer). The performance of these important tasks by music publishers allows songwriters to focus on their craft, and provides critical protection for the fruits of their endeavors.

334. Among the most important administrative duties is copyright registration, including with the U.S. Copyright Office and international collecting societies. Peer WDT (CO Trial Ex. 13) at 16; 2/5/08 Tr. at 1612-13 (Peer); 1/29/08 Tr. at 407-08 (Faxon); Firth WDT (CO Trial Ex. 24) at 20; Robinson WDT (CO Trial Ex. at 8) at 20; *see also* Israelite WDT (CO Trial Ex. 11) at 6-7.

335. On behalf of songwriters, music publishers engage in licensing and royalty administration. For mechanical licenses, music publishers will either work through the HFA structure or license songs in their catalogs directly. Faxon WDT (CO Trial Ex. 3) at 11; *see also* 1/29/08 Tr. at 408-09; 1/31/08 Tr. at 952 (Robinson); Firth WDT (CO Trial Ex. 24) at 17; 2/12/08 Tr. at 2681 (Firth). Many music publishers have administrative staffs dedicated exclusively to handling mechanical licensing activities. *See* Firth WDT (CO Trial Ex. 24) at 17; *see also* 2/5/08 Tr. at 1613 (Peer). In most cases, performance rights are licensed through the performance rights organizations, ASCAP, BMI and

SESAC. *Id.* Synchronization and print rights are licensed directly. Faxon WDT (CO Trial Ex. 3) at 11.

336. Music publishers have also eagerly accepted opportunities to license their musical compositions for a variety of new or developing uses. *See* Faxon WDT (CO Trial Ex. 3) at 18-20; Firth WDT (CO Trial Ex. 24) at 20-21. Peermusic, for example, entered into an agreement with Musicnotes, Inc., to license digital sheet music on the Internet, thereby guaranteeing both easy public access to print versions of the Peermusic catalog and proper compensation for songwriters. Peer WDT (CO Trial Ex. 13) at 16. BMG MP entered into a similar agreement with Gracenote, a digital company seeking to distribute song lyrics on the Internet. Firth WDT (CO Trial Ex. 24) at 21.

337. Music publishers were also integral to the creation of the ringtone market by granting early licenses to ringtone aggregators for the use of their musical compositions as monophonic and polyphonic ringtones. Peer WDT (CO Trial Ex. 18) at 17; Robinson WDT (CO Trial Ex. 8) at 12; Firth WDT (CO Trial Ex. 24) at 21. Most significantly, many music publishers, through NMPA, entered into the 2001 agreement with the RIAA to enable online subscription services to offer limited downloads and interactive streams on a rateless basis, pending future negotiations or rate setting proceedings. Robinson WDT (CO Trial Ex. 8) at 8; 1/31/08 Tr. at 934-36 (Robinson). As Mr. Robinson testified, “[w]e were all interested in broadening the market for the use of music. So we agreed to give a license which didn’t have a rate attached to it.” 1/31/08 Tr. at 935 (Robinson); *see also* 1/29/08 Tr. at 413-14 (Faxon).

338. Once the songs in a music publisher’s catalogs are licensed, it typically falls to the music publisher to collect and audit royalties that are subsequently owed.

Overall, administering and monitoring licenses in this way is a major endeavor for music publishers. Peer WDT (CO Trial Ex. 13) at 17. It is one of the most important steps in ensuring that songwriters are properly compensated for their work, but also, typically, one of the most complicated. Firth WDT (CO Trial Ex. at 24) at 17; *see also* Robinson WDT (CO Trial Ex. 8) at 20-21; 2/5/08 Tr. at 1614 (Peer). Accordingly, the opportunity to rely on a music publisher's skill and experience in this regard is a substantial benefit for songwriters, and is, in fact, why many songwriters enter into "administration only" deals pursuant to which music publishers will offer royalty collection services to the owners of copyrights that are not formally part of a music publisher's catalog. Peer WDT (CO Trial Ex.13) at 16-17.

339. Finally, music publishers represent the interests of their songwriters in a variety of legal matters to protect their creative and financial interests, ranging from infringement actions to rate-setting proceedings such as this. Peer WDT (CO Trial Ex. 13) at 17. Many of these efforts are coordinated by NMPA. *See* Israelite WDT (CO Trial Ex. 11) at 3-4; Robinson WDT (CO Trial Ex. 8) at 2-3; *see also* 1/29/08 Tr. at 371-72 (Faxon); 2/5/08 Tr. at 1614-15 (Peer).

340. Consolidating these administrative functions, which impact each of the thousands of individual songwriters currently active in the U.S. music industry, into the hands of music publishing companies is far more efficient for the industry as a whole. Peer WDT (CO Trial Ex. 13) at 17. More important, perhaps, when music publishers take care of complex administrative tasks such as those described above, songwriters have more time to devote to the creative process. As Mr. Peer explained, "our ability to provide these services permit songwriters—who would otherwise have to devote

considerable time, energy and expense to such tasks—to concentrate their efforts on their musical careers.” Peer WDT (CO Trial Ex. 13) at 17. Ms. Shaw agreed, testifying that “[m]usic publishers have allowed me to focus on the creative process of songwriting by focusing on the administrative details of getting a song recorded,” Shaw WDT (CO Trial Ex. 5) at 6, and that she has more time to write songs when publishers take care of the substantial amount of paperwork that is necessary in her profession. 1/30/08 Tr. at 832 (Shaw). Again, as Mr. Bogard emphasized, the more time a songwriter has to devote to activities other than writing songs, the more his or her creative output will suffer. Bogard WDT (CO Trial Ex. 2) at 8. Due in large part to the efforts of music publishers, the reverse is also true.

C. Music Publishers Depend Heavily on Mechanical Royalties

341. Mechanical royalties are an important source of income for music publishers. According to Professor Landes, mechanical royalties represent in the range of 30 to 65 percentage of total publisher royalties for six publishers. Landes WDT (CO Trial Ex. 22) at 15; Figure 1. Mr. Peer, for example, testified that over 50% of his company’s income was derived from mechanical royalties. 2/5/08 Tr. at 1620 (Peer); 5/18/08 Tr. at 6360 (Faxon). Mr. Firth presented similar testimony that mechanical royalty revenues represented 56% of BMG MP’s total revenues in 2005. Firth WDT (CO Trial Ex. 24) at 22; *see also* Santisi WRT (RIAA Trial Ex. 78) 48-52.

342. Music publishers rely on their mechanical income to finance the work they perform on behalf of songwriters, as both music publishers and their songwriters have recognized. Both Mr. Robinson and Mr. Peer testified that mechanicals are the most significant income stream against which their companies are able to recoup advances to songwriters. *See* 1/31/08 Tr. at 966 (Robinson); 2/5/08 Tr. at 1619 (Peer). Songwriter

Rick Carnes also explained that, just as he depends on mechanical royalties, so do music publishers and a “decrease in the mechanical rate would impair their ability to develop talent and cause them to sign fewer artists.” Carnes WDT (CO Trial Ex. 1) at 8.

1. Mechanical Royalties Received by Music Publishers Are Declining

343. For the reasons stated above, mechanical royalties earned by music publishers, and the songwriters they represent, have declined over the past few years. HFA collects the largest share of mechanical royalties each year, and HFA’s financial statements for 2001 and 2006 show a significant decline in the licensing revenue generated from mechanical royalties. CO Trial Exs. 12A, 12B. In addition, the financial statements of individual music publishers show a decline as well. Both smaller music publishers, such as Famous, and the current largest music publisher, EMI MP, have experienced declines in mechanical royalty revenues. *See* CO Trial Ex. 9; RIAA Trial Ex. 15; Santisi WRT (RIAA Trial Ex. 78) at 49; CO Trial Ex. 375, Ex. A; 5/7/08 Tr. at 5214 (Santisi). Significantly, the decline in mechanical royalties earned by many music publishers has occurred despite new catalog acquisitions, increasing market share or other forms of corporate growth. Faxon WRT (CO Trial Ex. 375) at 2; 5/14/08 Tr. at 6355-57 (Faxon).

2. Publishers Need an Increase in the Mechanical Royalty Rate

344. Each of the testifying music publishers concluded that the current mechanical royalty rate does not adequately reflect the value of or properly compensate them for the contributions they make to the music industry. *See generally* Faxon WDT (CO Trial Ex. 3) at 21-27; Robinson WDT (CO Trial Ex. 8) at 3-9; 1/31/08 Tr. at 1042 (Robinson); Peer WDT (CO Trial Ex. 13) at 19-25; Firth WDT (CO Trial Ex. 24) at 1;

see also 2/12/08 Tr. at 2648, 2713-14 (Firth); *see also* Israelite WDT (CO Trial Ex. 11) at 7-11.

345. The rates in place today do not properly reflect current industry and market conditions. They are the result of a negotiated settlement reached in 1997, when the physical music market was flourishing and the digital music market was barely in existence. Robinson WDT (CO Trial Ex. 8) at 4-5; *see also* 1/31/08 Tr. at 929-32 (Robinson). None of the parties to this proceeding dispute the dramatic changes that have taken place since then. *See* Israelite WDT (CO Trial Ex. 11) at 7-8; Wilcox WDT (RIAA Trial Ex. 70) at 5-7; Munns WDT (RIAA Trial Ex. 76) at 2. Mr. Robinson, for one, testified that it is important to adjust the current rates to account for these changes and adequately and fairly compensate music publishers today and in the future. *See* Robinson WDT (CO Trial Ex. 8) at 3-7.

346. The dramatic growth of the permanent download market has been one of the most significant of those changes. As Mr. Israelite testified, the current rate for permanent downloads was “agreed to in the absence of any hard evidence of the economics of digital distribution or any clear understanding of the future of the digital distribution of music.” Israelite WDT (CO Trial Ex. 11) at 9; *see also* Robinson WDT (CO Trial Ex. 8) at 5. Having watched the permanent download market grow substantially since initial rates were set, the music publishers believe that adjusted rates must reflect current realities in the digital music market, including the increased value consumers receive from digital music and the development of the singles-based digital market. Faxon WDT (CO Trial Ex. 3) at 25-26; *see also* 1/29/08 Tr. at 429-30 (Faxon);

Robinson WDT (CO Trial Ex. 8) at 5); 1/31/08 Tr. at 937-38, 976, 1038-39 (Robinson); 2/5/08 Tr. at 1634-35 (Peer).

347. Irrespective of the recent industry changes, the current mechanical royalty rates no longer provide adequate compensation to songwriters and music publishers because, as Mr. Peer testified, mechanical royalties have been, and continue to be, depressed by a number of external factors. Peer WDT (CO Trial Ex. 13) at 20. Mr. Firth, among others, agreed with Mr. Israelite's statement that the "[s]tatutory rate has become a frequently unobtainable ceiling on the royalties music publishers and songwriters are actually paid." Israelite WDT (CO Trial Ex. 11) at 10. As discussed in detail in section 4.C.2.c, the expanded use of controlled composition clauses, in particular, has reduced the amount of mechanical royalties received by songwriters and music publishers, and increased the disparity between what the owners of musical compositions earn under the mechanical license and what they earn from other licensing opportunities for the same musical works. Firth WDT (CO Trial Ex. 24) at 2; 2/12/08 Tr. at 2649-50, 2652 (Firth); *see also* Robinson WDT (CO Trial Ex. 8) at 9; 2/5/08 Tr. at 1639-44 (Peer); 1/29/08 Tr. at 426-28 (Faxon).

348. Mechanical royalties have been further depressed as a result of the dramatic rise of music piracy in the late 1990s, which led to a significant decline in legitimate music sales. *See* Israelite WDT (CO Trial Ex. 11) at 9-10; 1/31/08 Tr. at 937 (Robinson). Songwriters and music publishers have been particularly hard hit by the loss of revenue attributable to piracy, which has "in effect, further reduced the average, effective royalty rate that songwriters have received on the total number of copies that have been distributed." Robinson WDT (CO Trial Ex. 8) at 6. As a result, songwriters

and music publishers are further under-compensated for making an effort to produce great music, and have less incentive to continue to do so.

349. Overall, as Mr. Faxon noted, the value of musical compositions has increased in recent years, thanks in large part to the efforts of songwriters and music publishers. Faxon WDT (CO Trial Ex. 3) at 25. Without an increase in the mechanical royalty rate it will become increasingly difficult to sustain such efforts. *See* Firth WDT (CO Trial Ex. 24) at 24. As a number of these witnesses emphasized, the most fundamental justification for an increased rate is to allow both songwriters and music publishers to receive “compensation that is adequate to encourage their continued investments of time and creativity.” Robinson WDT (CO Trial Ex. 8) at 21; *see also* Peer WDT (CO Trial Ex. 13) at 25; *see also* 2/5/08 Tr. at 1638 (Peer); 1/29/08 Tr. at 415-16, 530 (Faxon).

VI. The Copyright Users

A. Overview of the Record Companies

350. In the mid-1990s, six major recorded music companies dominated the U.S. recorded music industry: Warner Music Group, Universal Music Group, EMI Music, Sony Music, BMG Entertainment and PolyGram. With the acquisition of PolyGram by Universal in 1998 and the joint venture formed between Sony and BMG in 2004 (Sony BMG Music Entertainment, “Sony BMG”), today there are four remaining major record companies (Sony BMG, Warner, Universal and EMI). Wilcox WDT (RIAA Trial Ex. 70) at 4; H. Murphy WDT (CO Trial Ex. 15) at 11 n.20. The four major record companies now produce approximately 70% of the recorded music sold in the U.S. 1/13/08 Tr. at 3027 (McLaughlin); 5/8/08 Tr. at 5566 (Benson); Benson WRT (RIAA Trial Ex. 82) at 38; Barros WDT (RIAA Trial Ex. 74) at 5.

351. The remaining share of the U.S. market is divided among smaller, independent record companies such as Concord Music Group, American Gramophone, Equity Music Group, Koch Records, Red Ink and TVT Records. Enders WDT (CO Trial Ex. 10) at 26; Barros WDT (RIAA Trial Ex. 74) at 5. The independent record companies produce 25-30% of the unit sales of albums in the U.S. recorded music market. Barros WDT (RIAA Trial Ex. 74) at 5-6; 2/21/08 Tr. at 4105-06 (Barros).

B. Overview of the Digital Music Companies

352. Today, the companies that provide digital music are generally divided into two categories: companies solely in the permanent download business and companies in the subscription service business, which offer mainly limited downloads and interactive streams, and sometimes permanent downloads. All four major U.S. wireless phone operators—Cingular, Sprint, T-Mobile, and Verizon—provide digital music in the form of ringtones or permanent downloads directly to consumers' cellular phones and other wireless devices. Enders WDT (CO Trial Ex. 10) at 42-43.

353. The permanent download business is dominated by Apple, which sells downloads to consumers through its iTunes Store. Apple's iTunes Store has a market share of approximately 85% of the legal permanent download market. Enders WDT (CO Trial Ex. 10) at 28; 2/4/08 Tr. at 1178-80 (Enders). Apple's iPod, a music player that works in conjunction with the iTunes Store and software platform, dominates the portable digital player market in similar fashion, claiming over 75% market share in the second quarter of 2006. Enders WDT (CO Trial Ex. 10) at 10.

354. A number of other retailers currently sell permanent downloads, including Wal-Mart, Microsoft and Amazon. *Id.* at 27; *see also* 5/6/08 Tr. at 4832 (Guerin-Calvert). Subscription services that offer consumers a variety of limited download and

interactive streaming options for a regular (typically monthly) fee, such as Napster and Rhapsody, often also sell permanent downloads, with some services, such as Rhapsody, allowing subscribers to “upgrade” limited downloads to permanent downloads for a minimal additional fee. Enders WDT (CO Trial Ex. 10) at 33.

VII. Significant Developments in the Recorded Music Market

355. Throughout this proceeding, witnesses from record companies and digital media companies have attempted to paint a picture of irreparable financial woe resulting from declining sales and revenues. See Munns WDT (RIAA Trial Ex. 76) at 2-3; C. Finkelstein (RIAA Trial Ex. 57) at 4-5; Guerin-Calvert WDT (DiMA Trial Ex. 7) at 16-23 (discussing recent changes in the industry and the negative impact of piracy). The evidence, however, revealed a very different reality: the record companies and digital media companies of today—enjoying in some instances record profits—are in a healthy financial state and face an ever brighter future. *See generally* Enders WDT (CO Trial Ex. 10); H. Murphy (CO Trial Ex. 15).

A. The Recorded Music Business Is Cyclical

356. The recorded music industry historically has undergone cyclical growth and profitability. H. Murphy WDT (CO Trial Ex. 15) at 4; 2/6/08 Tr. at 1763-64 (H. Murphy). Since 1969, the recorded music industry has experienced two periods of rapid growth. Each phase of growth (followed by a brief downturn) was driven by a new format and new technology. H. Murphy WDT (CO Trial Ex. 15) at 9-10.

357. The first growth phase, between 1969 and 1979, was driven by the introduction and market penetration of the cassette player, which allowed full portability of music for the first time. *Id.* at 9; see also CO Trial Ex. 16; 2/6/08 Tr. at 1765 (H.

Murphy). During this period, the major record companies expanded their music manufacturing and distribution operations. H. Murphy WDT (CO Trial Ex. 15) at 9.

358. In the early 1980s, the recorded music industry experienced a period of contraction for two principal reasons. First, the industry encountered a period of economic recession. Second, piracy in the form of copying music on cassettes plagued the industry. As a result, worldwide sales declined by an annual rate of 4.1% between 1980 and 1984. *Id.* at 9-10.

359. Following this brief period of decline, however, the recorded music industry enjoyed a long period of prosperity. From the mid-1980s through the mid-1990s, this growth was fueled by the introduction of, and industry conversion to, a new music format, the CD, which had a number of advantages over the LP and cassette including superior sound quality. *Id.*

360. The compound annual growth rate (“CAGR”) of the recorded music industry in this period was approximately 15% worldwide. *Id.* The U.S. recorded music industry grew from \$4.3 billion in 1984 to \$12.3 billion in 1996. *Id.* at 10 n.19. The profits of the major record companies increased during this time period as well. Their combined profits grew from \$62 million in 1991 to \$269 million in 1995. *Id.* at 14, Ex. 3A. At that time, market participants, including the record companies and music publishers, expected that the growth in sales of CDs would continue. Robinson WDT (CO Trial Ex. 8) at 4; Israelite WDT (CO Trial Ex. 11) at 8.

361. During that time, the principal form of distribution of music was through physical products, such as vinyl records, cassette tapes and CDs, with CDs constituting

the dominant format for music sales in the U.S. for well over a decade. McLaughlin WDT (RIAA Trial Ex. 56) at 20; Munns WDT (RIAA Trial Ex. 76) at 5.

B. Digital Distribution of Music Began in the Late-1990s

362. In the 1990s, personal computers equipped with CD-ROM drives grew increasingly prevalent. Enders WDT (CO Trial Ex. 10) at 9-10. Because the record companies had chosen not to put copy protection on CDs, a decision disputed by songwriters and music publishers, this development enabled PC-users to copy audio files from CDs onto their personal computers. *See* 2/5/08 Tr. at 1397-98 (Israelite) (discussing the record companies' "very poor decision to not put copy protection on disks," how that decision was made without songwriter or music publisher input, and the consequences of said decision); 2/20/08 Tr. at 4013-15 (Wilcox) (conceding that currently all CDs that Sony sells to the public are capable of being copied). With the development of the MP3 file format, users could then compress those audio files, making them easier to distribute over the Internet. At the same time, the Internet was becoming available to a growing number of consumers. These technological developments set the stage for a large-scale transition to the digital delivery of music over the Internet. *See* Enders WDT (CO Trial Ex. 10) at 10; *see also* H. Murphy WDT (CO Trial Ex. 15) at 11.

363. Although the major recorded music companies knew that the digital revolution had begun, and recognized that it required a completely different business model, they made very few strategic changes to prepare for the shift. H. Murphy WDT (CO Trial Ex. 15) at 11. Digital delivery of music represented a new challenge for the majors, which had always been in the business of selling, marketing, manufacturing and distributing physical product. *Id.* As Universal Music later admitted, for example, it had been neither aggressive nor decisive with its initial digital strategies. H. Murphy WDT

(CO Trial Ex. 15) Ex. COA 700 at RIAA 18076. Documents from EMI Music show similar realizations. As Mr. Munns confirmed, in November 2001, EMI's digital strategies were "focused on milking short-term cash opportunities." 2/26/08 Tr. at 4752 (Munns). When asked, David Munns, the former EMI Vice Chairman, confirmed that this was an accurate description of EMI's digital efforts at that time, and that EMI had not, by that point, made an adequate investment in the digital market. 2/26/08 Tr. at 4751-53 (Munns).

C. Digital Piracy Began in the Late-1990s

364. The absence of a viable Internet-based music service offering from the major record companies, and their delay in licensing third-party music services, fueled the demand for the illegal copying of digital music over the Internet. Enders WDT (CO Trial Ex. 10) at 10; H. Murphy (CO Trial Ex. 15) at 13.

365. In 1999, Napster launched a P2P file-sharing service that allowed users to make their MP3 files of digital music available for copying by other Napster users, enabling them to search for and copy desired music from one "peer" computer in the network to another over the Internet. Enders WDT (CO Trial Ex. 10) at 10-11; see also 2/4/08 Tr. at 1155 (Enders). Napster was shut down in July 2001, but a number of other P2P file-sharing networks, such as Grokster, Aimster, Gnutella, and Freenet, emerged to perpetuate Internet-based piracy of digital music. *Id.* at 11. The result was unprecedented levels of piracy in the music industry, with a peak level of 1.1 billion music files available for illegal copying in April 2003. Enders WDT (CO Trial Ex. 10) at 10.

366. Important anti-piracy litigation waged by the music publishers and record companies proved successful. See 2/20/08 Tr. at 3921-25 (Bassetti); Bassetti WDT

(RIAA Trial Ex. 68) at 15-16. According to the International Federation of the Phonographic Industry (“IFPI”), “[i]llegal file-sharing has remained relatively stable against the background of fast-growing broadband,” indicating that anti-piracy efforts may be stemming the tide. CO Trial Ex. 29 at CP 9008749. Nevertheless, piracy continues to plague the music industry, causing losses of legitimate sales to record companies, music publishers and songwriters alike. *See* Bogard WDT (CO Trial Ex. 2) at 10; 5/8/08 Tr. at 5393 (Slottje); Guerin-Calvert WDT (DiMA Trial Ex. 7) at 23; 2/19/08 Tr. at 3913-14 (Bassetti). According to the same IFPI report, “in 2006 some 20 billion illegal files were downloaded” worldwide. CO Trial Ex. 29 at 9008749.

D. The Legitimate Digital Music Market Has Grown Rapidly

367. In late 2001, the majors finally launched their own online music services, called MusicNet and Pressplay, which were subscription services offering consumers who subscribed the ability to access and play a large number of files through their PCs. 2/4/08 Tr. at 1155-57 (Enders); Enders WDT (CO Trial Ex. 10) at 11. At the time, MusicNet was owned by AOL Time Warner, Bertelsmann AG, EMI Group plc and RealNetworks, Inc.; Pressplay was owned by Sony Music Entertainment and Universal Music Group. *Id.*

368. The major record companies were initially unwilling to cross-license recordings between their two digital music services, thereby preventing each service from offering a full music catalog and hurting their chances of success in the marketplace. As Mr. Munns explained, “consumers don’t differentiate between companies when they are looking at the music they want to buy. Most people who have records at home couldn’t tell you which label or which company supplied that. They know it’s a Norah Jones record or a Coldplay record. They don’t know it was an EMI or a Sony record. So to go

to any store, even a digital store, that didn't have a full array of musical offering was unlikely to be attractive to the consumer.” 2/26/08 Tr. at 4754 (Munns).

369. Moreover, consumers were accustomed to permanent ownership of music, primarily in the form of records, cassettes and CDs, and also through permanent downloads illegally obtained from pirate websites. *See* 2/4/08 Tr. at 1166-67 (Enders). The consumer model offered by MusicNet and Pressplay—ownership that lapsed with an expired subscription—provided just the opposite.

370. Not surprisingly, MusicNet and Pressplay were unsuccessful in the marketplace. *Id.* at 1158. According to Mr. Munns, these record company digital services were “doomed to fail.” 2/26/08 Tr. at 4754 (Munns); *see also* Enders WDT (CO Trial Ex. 10) at 11-12; 2/25/08 Tr. at 4222 (Cue) (discussing Apple’s expectations that MusicNet and Pressplay would not be attractive to or successful with consumers).

1. The Permanent Download Market Began in 2003

371. In 2003, the legitimate digital music market finally took a turn towards success. Apple introduced the iTunes Music Store for Mac users in April and for PC users in October, offering consumers a serious legitimate alternative to piracy: the opportunity to purchase permanent downloads from an expansive catalog.⁷ Enders WDT (CO Trial Ex. 10) at 17; *see also* Cue WDT (DiMA Trial Ex. 3) at 4.

372. As Mr. Cue, the Vice President of iTunes, testified, the overall iTunes concept originally began in late 2000 as a computer jukebox or music management

⁷ The iTunes Store was not the first attempt to sell permanent downloads online; eMusic, a hybrid permanent download and subscription service through which consumers could purchase downloads for a monthly fee, launched in 1998. Offering only music from independent labels, however, the service gained little traction with consumers. Enders WDT (CO Trial Ex. 10) at 11; 2/4/08 Tr. at 1154-55 (Enders).

program, through which consumers could copy music from physical CDs onto their computers to store, organize and play. 2/25/08 Tr. at 4219-20 (Cue). The iTunes jukebox program was introduced in January 2001 and led to the development of the iPod, Apple's revolutionary portable digital music player, first introduced in October 2001. *Id.* at 4220; Enders WDT (CO Trial Ex. 10) at 17; 2/4/08 Tr. at 1161 (Enders). Thereafter, Mr. Cue and others began to develop the idea of the iTunes Store because they thought it would "be great if we could buy any song that you wanted, or any album that you wanted . . . right within iTunes so that when you purchase something, rather than having to rip the CD, it would automatically just appear in your iTunes jukebox, and then the next time you sync your iPod, it would automatically move to your iPod." *Id.* at 4221; *see also* Cue WDT (DiMA Trial Exhibit 3) at 4.

373. In 2002, Apple—trying to turn its idea into a marketplace reality—approached the record companies for licenses. 2/25/08 Tr. at 4222 (Cue). At the time, the record companies, hanging on to the hope that MusicNet and Pressplay might someday prove successful, refused to license music to Apple. *Id.* ("When we went to them to license the content, they basically told us that they really weren't interested in the model that we had because they were really doing their own thing."). During the period in which the record companies refused to license Apple, piracy "continued to take off even more." *Id.* at 4223.

374. In late 2002, Apple approached the record companies again, pointing out that "[p]iracy continued to run pretty rampant," and pitching, again, Apple's permanent download model. *Id.* Finally, the record companies realized that "sufficiently convenient access to music, ease of use and high sound quality" were necessary to encourage

consumers to choose legitimate digital music over illegal, pirated alternatives, and that no existing service had satisfied those requirements. Enders WDT (CO Trial Ex. 10) at 12. Ultimately, Apple secured licenses from each of the major record companies, as well as a number of independents. 2/25/08 Tr. at 4224 (Cue). In late 2002 and 2003, the record companies began licensing their catalogs to other third-party digital music services as well.

375. Under the licenses between Apple and the four major record companies, Warner, Sony BMG, and Universal each receive [REDACTED]. [REDACTED] See CO Trial Ex. 92 at DiMA 3781; CO Trial Ex. 90 at DiMA 3632; CO Trial Ex. 93 at DiMA 3717; Enders WDT (CO Trial Ex. 10) at 48; 2/4/08 Tr. at 1228 (Enders). EMI, the fourth major record company, receives [REDACTED]. CO Trial Ex. 91 at DiMA 3463; Enders WDT (CO Trial Ex. 10) at 48; *see also* 2/25/08 Tr. at 4327-29, 4336-40, 4347-50 (Cue) (discussing Apple's agreements with each of the major record companies). In this way, each record company is [REDACTED]. See 2/25/08 Tr. at 4328-29 (Cue) ([REDACTED]). According to Mr. Wilcox, the penny minimum in these agreements was specifically intended to preserve "the value of the music that we're presenting in the marketplace to consumers." 2/20/08 Tr. at 4019 (Wilcox).

376. [REDACTED]. [REDACTED]. See CO Trial Ex. 93. [REDACTED]. [REDACTED]. 2/25/08 Tr. at 4349 (Cue); Enders WDT (CO Trial Ex. 10) at 46. [REDACTED].

[REDACTED]. 2/25/08 Tr. at 4349-50 (Cue). [REDACTED]

[REDACTED]

[REDACTED] CO Trial Ex. 93 at DiMA 3723.

377. [REDACTED]. See CO Trial Ex. 91. [REDACTED]

[REDACTED]. 2/25/08 Tr. at 4337 (Cue). [REDACTED]

[REDACTED]. CO Trial Ex. 91 at DiMA 3463. [REDACTED]

[REDACTED]

[REDACTED]. *Id.*; 2/25/08 Tr. at 4328 (Cue).

378. [REDACTED]

[REDACTED] See CO Trial Ex. 92; CO Trial Ex. 90. [REDACTED]

[REDACTED]

[REDACTED]. CO Trial Ex. 92 at DIMA 3783. [REDACTED]

[REDACTED]. Enders WDT (CO Trial Ex. 10) at 46. [REDACTED]

[REDACTED]. CO Trial Ex. 90 at 3632; 2/25/08 Tr. at 4348 (Cue).

379. The agreements between Apple and the record companies contain several notable provisions in addition to their pricing terms. [REDACTED]

[REDACTED]

[REDACTED]. Enders WDT (CO Trial Ex. 10) at 46; 2/4/08 Tr. at 1228 (Enders);

2/25/08 Tr. at 4329 (Cue); 2/20/08 Tr. at 4027 (Wilcox). [REDACTED]

[REDACTED]. Enders WDT (CO Trial Ex. 10) at 47;

2/25/08 Tr. at 4283 (Cue).

380. At the iTunes Store’s launch and continuing today, Apple set its price for single tracks at 99 cents and most digital albums at \$9.99. *See* 2/25/08 Tr. at 4265-66 (Cue). Apple, as well as other participants in the proceeding, have repeatedly proclaimed its 99 cent price point to be the magical number needed to “compete with free.” *See* 2/25/08 Tr. at 4239-44 (Cue) (explaining that pricing under \$1.00 would make a significant difference and be “very effective at getting consumers to switch [from free] and buy from us.”). Nevertheless, Apple confessed that no formal price sensitivity study had ever been conducted to validate Apple’s pricing plan. *Id.* at 4332-33. To the contrary, as Mr. Cue conceded, the 99 cent price point for digital singles was “an article of faith” for Apple. 2/25/08 Tr. at 4315 (Cue). And Mr. Cue and other witnesses steadfastly testified that Apple was unwilling to adjust its price, despite repeated requests to do so. *Id.* at 4315-16, 4267-68, 4331-35; *see also* 2/20/08 Tr. at 4027-28 (Wilcox) (explaining Sony’s longstanding interest in variable pricing for permanent downloads).

2. iTunes Has Become Incredibly Successful

381. The iTunes Store—initially offering a catalog of 200,000 songs and today offering well over 6 million—met with immediate success, selling one million songs in only six days. 2/25/08 Tr. at 4246, 4236 (Cue). Sales growth has continued, and the

number of songs sold through the iTunes Store on an annual basis has increased each year since its launch. *Id.* at 4263-64. In 2006, the U.S. iTunes Store sold approximately [REDACTED] million songs per week (including single tracks and songs within albums or bundles) on average. This number rose to [REDACTED] million per week on average in the first half of 2007, Enders WDT (CO Trial Ex. 10) at 14-15, putting the iTunes Store on track to sell roughly [REDACTED] songs in that period, 2/4/08 Tr. at 1188-89 (Enders). As noted above, Apple commands approximately 85% of the legal permanent download market today. Enders WDT (CO Trial Ex. 10) at 28; 2/4/08 Tr. at 1178-80 (Enders).

382. Apple has kept little secret about its recipe for success. Its music business model centers around selling its iPods, as well as iPod-related accessories such as speakers and headphones. Enders WDT (CO Trial Ex. 10) at 29-30. To that end, Apple has promoted the seamless experience provided by its “complete ecosystem,” as Apple calls it, with the frequent introduction of new or updated music players and other devices, including the iPod mini in January 2004, the iPod Photo in October 2004, the iPod shuffle in January 2005, the iPod Nano in September 2005 and the iPod with video capability in October 2005. *Id.* at 14. Of Apple’s \$9.6 billion in music and music-related revenue in FY 2006, 80.3% of Apple’s revenue was derived from the sale of iPods, with profit margin on iPod sales in excess of 20%. (The rest came from the sale of music and accessories on the iTunes Store.) Thus, the sale of music, alone, is a small part of Apple’s \$19.3 billion in total annual revenue. Enders WDT (CO Trial Ex. 10) at 29.

383. Indeed, Peter Oppenheimer, Apple’s CFO, has publicly stated: “Our philosophy has been to run the music store just a little bit over breakeven because we think that selling music and now videos, helps us to sell iPods and accessories. So that’s

been our strategy . . . I think the strategy is working extremely well.” CO Trial Ex. 88 at 12; *see also* CO Trial Ex. 89 at 10 (Oppenheimer, stating, “Our objective with the iTunes Store is to run it just a little above break even and we think that it helps us sell iPods and Macs and that is really our strategy.”). Of course, as detailed below in Sections VIII.B and X, the financial results of the iTunes Store are far better, soaring in recent years to profits “[REDACTED].” 2/25/08 Tr. at 4295 (Cue); *see also* CO Trial Ex. 85.

384. Mr. Cue [REDACTED] 2/25/08 Tr. at 4305 (Cue) (“[REDACTED]”).

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]. Enders WDT (CO

Trial Ex. 10) at 29-30. The success of the iTunes Store also helps Apple sell its Mac line of personal computers. *Id.* at 30.

385. This close relationship between the iTunes Store and iPods was achieved by careful design. *See* 2/25/08 Tr. at 4304 (Cue). Since the start, Apple has sold downloads that are compressed and encoded in a special format—the AAC file format, rather than the MP3 format used by other legal and illegal services—that works in conjunction with a proprietary digital rights management (“DRM”) software called Fairplay. Cue WDT (DiMA Trial Ex. 3) at 7, 29; *see also* Enders WDT (CO Trial Ex. 10) at 13 n.21, 29 n.65. As a result, music purchased from the iTunes Store can only be played through the iPod family of music players or a similarly authorized device (such as a personal computer). Cue WDT (DiMA Trial Ex. 3) at 7; Enders WDT (CO Trial Ex.

388. The growth in the permanent download market has positively affected subscription services as well, as Napster, RealNetworks and MusicNet are all generating increasing amounts of revenue from their permanent download services. In FY 2004, Napster, for example, generated [REDACTED] in permanent download revenues. By the end of FY 2006, that total had grown dramatically, to roughly [REDACTED], or [REDACTED] of total revenues. *Id.* at 36. MusicNet reported permanent download revenues of approximately [REDACTED] in 2004, and [REDACTED] in 2005, accounting for roughly [REDACTED] of total annual revenues. *Id.* at 39. By August 2006, MusicNet had already generated [REDACTED] in permanent download sales. *Id.* Rhapsody has reported similar revenue figures, generating a total of roughly [REDACTED], or [REDACTED] of total revenues, in permanent download sales to both subscribers and non-subscribers in FY 2005. *Id.* at 40. Reports through the first quarter of FY 2006 indicated [REDACTED] of this segment of these companies' businesses. *Id.*

4. Consumers Prefer Permanent Downloads for a Variety of Reasons

389. Consumers identify several reasons for their widespread acceptance of the permanent download model, and their willingness to pay for songs from Apple's iTunes Store and other permanent download retailers. *See id.* at 20-22; 2/4/08 Tr. at 1170-77 (Enders).

390. First and foremost, consumers highlight the ability to [REDACTED] [REDACTED]. *See* Enders WDT (CO Trial Ex. 10) at 20-21. Consumers' desire to cherry-pick, in particular, has had a significant impact on the shape of the digital music market overall, which is driven by the sale of singles, as opposed to albums. *See* Enders WDT (CO Trial Ex. 10) at 6-7; *see also* 2/4/08 Tr. at

1248 (Enders); Landes WDT (CO Trial Ex. 22) at 6, 38-39. In 2006, for instance, revenues from the sales of singles accounted for █% of the revenue received from all permanent downloads. Landes WDT (CO Trial Ex. 22) at 39. That year, unit sales of single track downloads averaged 11.0 million per week, while weekly sales of albums averaged only 592,000. Enders WDT (CO Trial Ex. 10) at 24. Approximately █% of weekly revenue for Apple's iTunes Store is attributable to the sale of singles. Landes WDT (CO Trial Ex. 22) at 39.

391. Consumers also cite a host of other characteristics that add value to music purchased in the digital market. *See* Enders WDT (CO Trial Ex. 10) at 19-22; 2/4/08 Tr. at 1172-77 (Enders). Consumers appreciate the added convenience of being able to purchase digital music from their homes at any time, without having to go to a store during limited opening hours. Enders WDT (CO Trial Ex. 10) at 20-21. Consumers also value the immediate access they have to their online purchases, which play immediately upon download. *Id.* Further, consumers are attracted to the much broader catalog of digital music offered by digital music stores, especially as compared to the increasingly limited selection found at an already limited number of physical retailers. *Id;* *see also* Cue WDT (CO Trial Ex. 3) at 23 (remarking that through the iTunes Store, consumers have access to “musical works that are unable to obtain meaningful shelf space at physical retail outlets” as readily “as the hit records that dominate the aisles at CD stores.”).

392. Apple's internal consumer research, detailing iTunes Store customers' reasons for purchasing music online, proves this point:

395. Beginning in late 2004, the ringtone market shifted toward the sale of mastertones, which are ringtones produced from master recordings that require licensing by record companies. Music publishers were helpful in facilitating the growth of this market as well, as Mr. Robinson testified, by providing new licenses either independently or through the NDMAs. Robinson WDT (CO Trial Ex. 8) at 12, Exs. 101-110, 112-119; *see also* Peer WDT (CO Trial Ex. 13) CO Exs. 151, 152; CO Trial Ex. 3, CO Exs. 219-221; CO Trial Ex. 24, CO Exs. 252, 298, 332. In fact, as Mr. Faxon testified, music publishers were ready and willing to license their works for mastertones before the record companies were ready or willing to do so. *See* 1/30/08 Tr. at 611 (Faxon) (discussing how record companies refused to license ringtone aggregators for mastertones unless they were the direct licensee of rights from music publishers).

396. All four major U.S. wireless phone operators—Cingular, Sprint, T-Mobile, and Verizon—currently offer mastertones to their subscribers. Prices vary from around \$2.00 to \$2.50, depending on the user’s mobile plan. Enders WDT (CO Trial Ex. 10) at 42-43.

397. Full digital tracks can also be downloaded “over the air” directly to wireless devices. Enders WDT (CO Trial Ex. 10) at 43. Mobile full-track downloads are now available directly from Sprint and Verizon or through the “Napster Mobile” service for AT&T, Suncom Wireless and Cellularone subscribers. In most cases, when purchasing a mobile download, consumers are also allowed to download a copy of the sound recording to a PC as well, a practice known as “dual-downloading.” 2/4/08 Tr. at 1169 (Enders). As of October 2006, the price for full track dual-downloads sold by Verizon was \$1.99, and those sold by Sprint were priced at \$2.50 each. Enders WDT

(CO Trial Ex. 10) at 43. The market for full-track mobile downloads is only beginning to emerge in the U.S., particularly in comparison to ringtones, but the spread of music-enabled cellular phones is expected to fuel future growth in the next few years. *See* Enders WDT (CO Trial Ex. 10) at 25, 42-43.

F. The Record Companies Have Restructured Their Businesses

398. As the digital market evolved, and Apple achieved resounding success, the recorded music industry underwent a period of restructuring and reorientation that has increased record company margins and profits. H. Murphy WDT (CO Trial Ex. 15) at 15.

399. Burdened by manufacturing plants dedicated to the flagging physical market, among other bloated costs, in 2001 the major record labels began significant restructuring programs. *Id.* Mr. Faxon, for example, testified that EMI MP's recorded music business was restructured in recognition of the fact that "the business had become bloated and . . . was overstaffed and that its expenses were out of line with its potential revenues." 1/30/08 Tr. at 558 (Faxon). The programs included: headcount reduction; the sale of LP, cassette and CD manufacturing facilities; the sale of their distribution affiliates and record club operations; the consolidation of owned labels to create greater scale efficiencies; compensation restructuring; and reduced capital expenditures. H. Murphy WDT (CO Trial Ex. 15) at 15; *see also* 1/30/08 Tr. at 557-63 (Faxon); Teece WDT (RIAA Trial Ex. 64) at 88; Munns WDT (RIAA Trial Ex. 76) at 11-12.

400. An internal Universal Music presentation spotlighted why such extensive restructuring was necessary: "[t]alent/recording costs were spiraling out of control," "[m]arketing costs were following suit," and the record companies were maintaining a

“[b]loated overhead/cost structure.” H. Murphy WDT (CO Trial Ex. 15), Ex. 700 at RIAA 018075.

401. The subsequent restructurings cut the record companies’ payrolls significantly. In the case of one major record company, Warner, worldwide personnel were reduced from approximately 12,996 employees to 4,000 employees over the 1997 to 2006 period, for a reduction of approximately 69%. H. Murphy WDT (CO Trial Ex. 15) at 15. EMI reduced its worldwide headcount from approximately 10,500-11,000 employees in 2001 to 5,500-6,000 in 2007, with plans to reduce another 1,500-2,000 employees in the future. 1/30/08 Tr. at 560-63 (Faxon). Other major record companies have experienced similar reductions in total personnel. H. Murphy WDT (CO Trial Ex. 15) at 15. As a result of the labels’ restructurings, the total number of employees of the major U.S. record labels declined by more than 50% between 2001 and 2005. *Id.* at Ex. 5A; *see also* Teece WDT (RIAA Trial Ex. 64) at Errata No. 4b (Ex. 21-Corrected).

VIII. The Current State of the Recorded Music Industry

402. Today, although sales of CDs continue to decline, the U.S. digital music market—far from a “nascent,” “unstable” market, as several DiMA witnesses contended—is flourishing. Guerin-Calvert WDT (DiMA Trial Ex. 7) at 24. As U.S. consumers appear increasingly willing to pay for legitimate digital music, sales of digital music across a variety of formats are rapidly rising, further increasing the size of the U.S. digital music market and the profitability of the recorded music and digital music companies. Enders WDT (CO Trial Ex. 10) at 25-26.

A. U.S. Physical Music Sales Are Declining

403. Sales of CDs have fallen since 1999. H. Murphy WDT (CO Trial Ex. 15) Ex. 2A. According to the RIAA, the major record companies’ wholesale revenue from

CD sales fell from \$5.3 billion in 1999 to \$3.8 billion in 2006, representing a CAGR of -4.5% over that time period. Benson WRT (RIAA Trial Ex. 82) at 23.

404. During the 1999-2006 time period, CD albums fell from 89.7% of net sales revenue by format to 80.5% of net sales revenue by format. *Id.*

405. According to the IFPI, CD units shipped in the U.S. fell from 803.3 million in 2002 to 614.9 million in 2006. CO Trial Ex. 29 at CO 9008767.

B. U.S. Digital Music Sales Are Growing Rapidly

1. Total U.S. Digital Music Sales

406. While the physical market has been declining, the digital market has been dramatically on the rise. In 2007, total U.S. digital music sales (online and mobile) were estimated to be approximately \$2.7 billion in 2007, growing from more than \$1 billion in 2005 and from \$1.859 billion in 2006. Enders WDT (CO Trial Ex. 10) at 22; 2/4/08 Tr. at 1246-47 (Enders). Today, the U.S. digital music market is the largest digital music market in the world, representing 52% of global digital sales. CO Trial Ex. 29 at CO 9008757.

407. The contribution of digital music to total U.S. recorded music sales is also increasing rapidly. In 2004, digital music sales constituted 1.5% of total U.S. recorded music sales, rising to 8.8% of such sales in 2005, and 17% in 2006. Enders WDT (CO Trial Ex. 10) at 23. The total value of U.S. digital music sales in 2007 was approximately 30% of total recorded music sales. 2/4/08 Tr. at 1246-47 (Enders).

408. As discussed below, the U.S. digital music market is composed of online music services (58% of total sales) and mobile services (42% of total sales). Enders WDT (CO Trial Ex. 10) at 23.

2. Online Music Services

409. In 2006, online music services generated sales of approximately \$1.084 billion, of which about 81% was due to permanent download services and 19% to subscription services. Enders WDT (CO Trial Ex. 10) at 23.

410. From 2004 to 2005, dollar sales of digital single permanent downloads rose 163% to reach \$363.3 million, and rose 59.8% from 2005 to 2006 to reach \$580.6 million. From 2004 to 2005, dollar sales of digital album permanent downloads rose to \$135.7 million, and 103% to \$275.9 million from 2005 to 2006. Enders WDT (CO Trial Ex. 10) at 23.

411. The increase in dollar sales is being driven by a substantial increase in unit sales. Based on Nielsen Soundscan data of weekly sales, U.S. digital music unit sales are composed primarily of singles, not albums. Indeed, the IFPI has reported that the digital single is the fastest growing format in recorded music history based on the annual number of units sold. Enders WDT (CO Trial Ex. 10) at 23-24.

412. From 2004 to 2005, unit sales of digital single permanent downloads rose 163% to reach 366.9 million units, and from 2005 to 2006, rose by 59.8% to reach 586.4 million units. Measured on a weekly basis, unit sales of single permanent downloads grew from 2.6 million per week in 2004 to 6.5 million per week in 2005 and reached 11.0 million per week in 2006. Enders WDT (CO Trial Ex. 10) at 24.

413. Unit sales of digital album permanent downloads rose to reach 13.6 million units in 2005 and again in 2006 to reach 27.6 million units. Weekly sales of digital album permanent downloads averaged 592,000 in 2006, up from 303,000 in 2005 and 138,000 in 2004. Albums represented 4.5% of online purchases of digital formats in 2006. Enders WDT (CO Trial Ex. 10) at 23-24.

414. Data from Apple's iTunes Store, the leading digital music retailer, show that weekly sales continued to increase in 2007, rising to [REDACTED] million songs per week (single tracks and tracks within albums) in the first half of 2007. Enders WDT (CO Trial Ex. 10) at 24.

3. Mobile Music Services

415. Sales of mobile music formats are also growing rapidly. This market generated sales of \$421.6 million in 2005 and \$774.5 million in 2006, which represents 83.7% growth from the year before, and is forecasted to reach an estimated \$1.8 billion by 2012, as discussed below. Enders WDT (CO Trial Ex. 10) at 15, 25, 56-57.

416. The most established mobile music market is for ringtones: about 41 million Americans downloaded ringtones in the first quarter of 2007. Mastertones accounted for \$654.3 million of total mobile music revenue in 2006, while full track mobile downloads generated \$34.2 million in 2006; and 262.8 million mastertones were purchased in 2006, compared to 17.2 million full track downloads. Enders WDT (CO Trial Ex. 10) at 26.

IX. The Current Financial Condition of the Record Companies

417. Notwithstanding the RIAA's claims throughout this proceeding that record companies are struggling, the evidence adduced at trial presents a far different picture. Although the record companies' top-line revenues have declined over the last decade, their profitability has, in fact, increased to record highs as a result of the growth of digital music sales and corresponding reduction in manufacturing and distribution costs for digital product. H. Murphy WDT (CO Trial Ex. 15) at 23.

A. Revenues

418. In 2006, U.S. recorded music retail sales amounted to approximately \$10.9 billion, and the total dollar value of U.S. recorded music wholesale sales was \$6.5 billion. Enders WDT (CO Trial Ex. 10) at 8 n.5; CO Trial Ex. 29 at CO 9008767.

419. Despite the decline in recorded music revenues caused by slowing physical sales, numerous RIAA witnesses acknowledged that record companies have begun to benefit from a variety of new revenue streams—most important, booming digital sales, which are quickly growing into a significant segment of the total U.S. recorded music market. Munns WDT (RIAA Trial Ex. 76) at 5; Kushner WDT (RIAA Trial Ex. 62) at 20; 2/20/08 Tr. at 4079-80 (Hughes).

420. Moreover, record companies are evolving into “music entertainment companies” with many alternative sources of revenue. *See* H. Murphy WDT (CO Trial Ex. 15), CO Ex. 700 at RIAA 0018080. Sony BMG, for example, claims to be taking advantage of new areas “such as concert promotion, artist management, TV production, merchandising and artist marketing.” CO Trial Ex. 213 at 68 (Bertelsmann Annual Report 2007). To that end, it is becoming more prevalent for record companies to enter into so-called “360 contracts” with artists, which give labels a share in artists’ revenues from a variety of sources, including concerts and merchandise, and even mechanical royalties. *Id.*; Santisi WRT (RIAA Trial Ex. 78) at 17 n.30; 2/26/08 Tr. at 4758 (Munns). Other important alternative—and increasing—sources of revenue for the record companies in today’s market include performing rights royalty collections, synchronization deals and artist/label joint ventures. CO Trial Ex. 29 at 3; 2/26/08 Tr. at 4756-57 (Munns).

B. Costs

421. Generally, record company costs consist of overhead, manufacturing and distribution, artist royalties, mechanical royalties, marketing, and advances and recording expenses. McLaughlin WDT (RIAA Trial Ex. 56) at 3; *see also* K. Murphy WRT (CO Trial Ex. 400) at 9. Despite persistent record company complaints that they require a drastic reduction in mechanical royalty costs to survive, the record evidence again shows otherwise. In the case of cost categories not imposed on the record companies by statute, record company costs continue to rise, with a critical exception: The transformation to the digital market has dramatically changed—and reduced to near elimination—the manufacturing and distribution costs incurred by the record companies.

1. Overhead

422. Overhead represents the most significant cost for the record companies. *See* CO Trial Ex. 41; Benson WRT (RIAA Trial Ex. 82) at 8; K. Murphy WRT (CO Trial Ex. 400) at 10 (Figure 1); 5/8/08 Tr. at 5619 (Benson). Overhead costs include the salaries, office space, utilities, and travel and entertainment expenses for record company personnel, as well as the labels' indirect costs of working with artists, marketing recordings, accounting, royalty processing and other administrative functions. McLaughlin WDT (RIAA Trial Ex. 56) at 15; 5/7/08 Tr. at 5263 (Santisi).

423. Contrary to the record companies' assertions that labels have been cutting overhead expenses, such costs actually increased for much of the period from 1999 to 2006, with only a slight decrease in the last few years. Benson WRT (RIAA Trial Ex. 82) at 8 (Figure 1); K. Murphy WRT (CO Trial Ex. 400) at 10 (Figure 1). Thus, the majors' total overhead costs increased from \$1.29 billion in 1999 to \$1.41 billion in 2003; by 2006, these costs had decreased to \$1.24 billion. Benson WRT (RIAA Trial Ex.

82) at 8 (Figure 1). The RIAA's own analysis shows that per unit overhead costs remain higher in 2006 than they were in 1999, increasing from \$0.16 in 1999 to \$0.18 in 2006. 5/8/08 Tr. at 5619-20 (Benson); Benson WRT (RIAA Trial Ex. 82) at 15 (Figure 4a).

2. Manufacturing and Distribution

424. The record companies' costs associated with supplying music in digital formats to online and mobile music providers are substantially lower than the costs associated with bringing CDs to market.

425. Record companies traditionally incur significant costs associated with the manufacture and distribution of physical products. Enders WDT (CO Trial Ex. 10) at 9. For example, in the physical world, record companies have to manufacture CDs, artwork for CD packaging and jewel cases. 2/13/08 Tr. at 3175 (C. Finkelstein). According to RIAA witness David Munns, the cost of manufacturing CDs is "60 or 65" cents per album. 2/26/08 Tr. at 4745 (Munns). Physical product distribution also results in costs of taking goods from a warehouse, shipping them to stores and maintaining inventory control systems. 2/13/08 Tr. at 3175 (C. Finkelstein).

426. Moreover, record companies incur so-called "return costs" in connection with physical distribution because record companies allow retailers to return CDs if they cannot sell them, which entitles the retailer to a full refund minus certain costs. 2/13/08 Tr. at 3174 (C. Finkelstein); 2/26/08 Tr. at 4746 (Munns). Returns can have a significant negative impact on a company's profitability. *Id.* For example, in 2007, return costs amounted to █████ of EMI's total revenue. H. Murphy WDT (CO Trial Ex. 15), Ex. 4A at 6.

427. Abundant record evidence in this case demonstrates the absence of all of the above costs in the digital world. Simply put, the record companies' costs of

manufacturing and distributing digital music are close to, if not at, zero. *See, e.g.*, CO Trial Ex. 262.

428. As Mr. Munns testified, in the digital world there are no manufacturing costs. 2/26/08 Tr. at 4746 (Munns). Likewise, Mr. Finkelstein testified that in the digital world there are no costs of manufacturing CDs, artwork or jewel cases. 2/13/08 Tr. at 3175 (C. Finkelstein). Glen Barros, President and CEO of the independent label Concord, agreed that for digital downloads, there are no costs of manufacturing CDs or printed liner notes, and no costs of “transportation of those physical goods.” 2/21/08 Tr. at 4113 (Barros). Nor does digital distribution involve any return costs. 2/26/08 Tr. at 4746-49 (Munns); 5/12/08 Tr. at 5735 (A. Finkelstein); 5/8/08 Tr. at 5577-78 (Benson); CO Trial Ex. 262.

429. The documentary evidence created by the record companies in the ordinary course of business (as opposed to for purposes of this litigation) confirms just that. For example, EMI Music North America’s digital profit and loss (“P&L”) statement for year-to-date September 2007 shows that manufacturing costs were zero percent of net sales, and distribution costs were [REDACTED] CO Trial Ex. 19; 2/13/08 Tr. at 3269 (C. Finkelstein).

430. EMI’s digital P&L is consistent with a statement by Eric Nicoli, former Chairman and CEO of EMI Group, in the company’s Annual Report for 2005: “Certain costs borne in the physical world such as manufacturing, returns and pick-pack-ship are not relevant for digital products. For physical products, these costs are in the range of 15 to 18 percent of sales.” CO Trial Ex. 45 at RIAA 0043152. Mr. Finkelstein conceded that Mr. Nicoli’s statement was equally true for the U.S. as it was for the rest of the

world. 2/13/08 Tr. at 3173 (Finkelstein). He also testified that distribution costs for digital product were “less” than for physical product. *Id.* at 3177.

431. In fact, for Sony BMG, a 2005 P&L statement that breaks out its “U.S. Digital Portion” from its “U.S. Label Operation” [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED] CO Trial Ex. 20.

432. With regard to Warner, Edgar Bronfman Jr., Chairman and CEO of Warner Music Group, announced to shareholders in the company’s 2005 Annual Report: “We derive an operating margin advantage in digital given the lack of inventory, distribution and returns expenses.” CO Trial Ex. 21 at 5.

433. Although the RIAA attempted to prove through rebuttal witness Bruce Benson that digital distribution costs constituted 10% of digital revenue, a white paper that Mr. Benson produced for his consulting firm in August of 2007, only a few months prior to his engagement in this case, argued the opposite. The white paper stated that “manufacturing, distribution and return costs . . . do not exist for digital sales,” as these costs “disappear with transition to digital.” CO Trial Ex. 262 at RIAA-MR 85; 5/8/08 Tr. at 5577-78 (Benson). Mr. Benson, a former Sony Music executive who had previously performed consulting work for a number of record companies, believed the white paper was accurate at the time it was published. 5/8/08 Tr. at 5592 (Benson). Mr. Benson further admitted that EMI’s digital P&L reflecting the absence of distribution costs for digital delivery of music, CO Trial Ex. 19, was consistent with his white paper. *Id.* at 5587-88.

3. Artist Royalties

434. Artist royalties—voluntarily negotiated by the record companies and representing their only other cost for creative input—have increased substantially as a fraction of total record label costs. K. Murphy WRT (CO Trial Ex. 400) at 12; Benson WRT (RIAA Trial Ex. 82) at 21. RIAA financial data presented in reports by Mr. Benson and Linda McLaughlin show that artist royalties expenses increased from 18% of the majors' net sales revenue in 1991 to more than 22% in 2006. CO Trial Ex. 41 at RIAA 0008423; Benson WRT (RIAA Trial Ex. 82) at 8 (Figure 1). These expenses totaled \$15.7 billion during the 1991-2006 time period. CO Trial Ex. 41; Benson WRT (RIAA Ex. 82) at 8; *see also* H. Murphy WDT (CO Trial Ex. 15) at 29.

4. Mechanical Royalties

435. Mechanical royalties over the same period were approximately 50% lower than artist royalties. Benson WRT (RIAA Trial Ex. 82) at 8 (Figure 1); McLaughlin WDT (RIAA Trial Ex. 56) at 5-6 (Figure 2); K. Murphy WRT (CO Trial Ex. 400) at 12. During the ten-year period from 1991 to 2001, mechanical royalties as a percentage of labels' total revenue ranged between 7 and 7.9%. CO Trial Ex. 41 at RIAA 0008423; Benson WRT (RIAA Trial Ex. 82) at 8 (Figure 1). From 2002 to 2006, mechanical royalties as a percentage of total revenue ranged from 8.2 to 10.3%. *Id.* During the 15-year period from 1991 to 2006, mechanical royalties have never been more than 11% of record labels' total costs. *Id.*

5. Marketing

436. RIAA financial data presented by Mr. Benson and Ms. McLaughlin show that during the period from 1991 to 2006, marketing expenditures increased slightly from

16% of labels' net sales revenue in 1991 to more than 17% in 2006. Benson WRT (RIAA Ex. 82) at 8 (Figure 1); CO Trial Ex. 41.

6. Advances and Recording Costs

437. According to RIAA financial data presented by Mr. Benson and Ms. McLaughlin, the record companies' advances and recording costs have fluctuated. These costs increased from \$259 million in 1991 to a high of \$459 million in 2003 before falling to \$246 million in 2006. Advances and recording costs decreased from 7.7% of labels' total sales revenue in 1991 to 4.6% of revenue in 2006. Benson WRT (RIAA Trial Ex. 82) at 8 (Figure 1); CO Trial Ex. 41.

C. Profitability

438. As a result of the dramatic growth of the digital market and significantly reduced manufacturing and distribution costs in recent years, the evidence presented by Mr. Benson and Ms. McLaughlin, witnesses for the RIAA, and Ms. Murphy, a witness for the Copyright Owners, reveals that record companies have been enjoying record profits in recent years. See CO Trial Ex. 41. This evidence—drawn directly from the financial statements of the major record companies—stands in stark contrast to their pleas of financial distress. See *id.*

439. In the direct phase of this proceeding, the RIAA presented financial information concerning the major record companies through their longtime expert economist, Ms. McLaughlin. Ms. McLaughlin's data, which presents combined financial results for the major record companies for the years 1991-2005 only, shows that their operating profits, after declining from 1998 through 2003, rebounded in 2004 and 2005. CO Trial Ex. 41 at 1. In those two years, operating profits were \$571 million and \$740 million, respectively—the two highest years of profits on an absolute basis during the 15-

year period. *Id.* Calculating the operating margins based on Ms. McLaughlin's data demonstrates that 2004 and 2005 were also the highest years of profits on a relative basis during the 15-year period. H. Murphy WDT (CO Trial Ex. 15) at Exhibit 3A. For those years, Ms. McLaughlin's data show operating margins of 9.8% (2004) and 12.2% (2005)—higher than any other years in the 1991-2005 time period. *Id.*

440. If anything, Ms. McLaughlin's data understates the profitability of the recorded music industry as a whole. Ms. McLaughlin admitted that her data excluded the record companies' manufacturing and distribution profits, even though according to her 2002 testimony before a California State Senate Judiciary Committee and State Senate Select Committee on the Entertainment Industry, record companies earned \$5 billion in profits on their manufacturing and distribution companies from 1991 to 2001. 2/13/08 Tr. at 3069-75; CO Trial Ex. 43 at RIAA 0008359. Her analysis pertains only to the major record companies and presents no information about the profits earned by the numerous record companies that make up the remaining 30% of the industry. *See* CO Trial Ex. 83 (2007 Concord Income Statements).

441. That the major record companies are now enjoying record profits is corroborated by record company documents and numerous statements by record company executives. H. Murphy WDT (CO Trial Ex. 15) at 18.

442. According to Warner's financial statements, Warner's ██████████ ██████████ in 2003 to ██████████ in 2006. H. Murphy WDT (CO Trial Ex. 15) at 18.⁸ Warner's increased profitability is due in part to the fact that digital products have

⁸ In calculating these margins, Ms. Murphy used the record companies' total revenues as the denominator, and used either OIBDA, EBITDA or pretax profit or net income as the numerator because each of the companies use slightly different measures of

higher profit margins, as information from its subsidiary labels shows. Those subsidiary labels reported margins on digital product for their 2006 forecast and 2007 budget that are higher than their margins on physical product, and the spread ranges from [REDACTED] to [REDACTED]. H. Murphy WDT (CO Trial Ex. 15) at 26, CO Ex. 714. Warner Brothers, Warner's largest label, reported in its 2007 budget a domestic gross margin of [REDACTED] for physical and [REDACTED] for digital (a margin spread of [REDACTED]). For its forecast 2006 period, it reported a gross margin of [REDACTED] for physical and a [REDACTED] margin for digital (a margin spread of [REDACTED]). *Id.* at RIAA 024964.

443. The financial results above are consistent with Mr. Bronfman's statement that the company enjoys an "operating margin advantage in digital." At trial, Michael Kushner, Senior Vice President for Business and Legal Affairs at Atlantic Records, a Warner subsidiary label, stated that he believed Mr. Bronfman's statement was accurate. 2/14/08 Tr. at 3490-91 (Kushner). Mr. Kushner also testified that Atlantic's digital gross margin was higher than its physical gross margin, and that he believes today that the record industry will emerge from its current transition period as a healthy industry, in part due to the great opportunities in the digital side of the business. *Id.* at 3482-87.

444. Universal's [REDACTED] in 2003 to [REDACTED] in 2006. H. Murphy WDT (CO Trial Ex. 15) at 18. [REDACTED]
[REDACTED]
[REDACTED] CO Trial Ex. 264; 5/8/08 Tr. at 5554 (Benson) (confirming that the profit earned by Universal Music Group in 2006 was [REDACTED]).

their profitability. She used EBITDA including VPA to calculate the margins for Universal. However, the underlying trend in profitability across the companies, with the exception of EMI, is consistent. H. Murphy WDT (CO Trial Ex. 15) at 18 n. 45.

445. Sony BMG's pretax profit ██████████ in 2003 to ██████ in 2006. H. Murphy WDT (CO Trial Ex. 15) at 18. Bertelsmann's 2007 annual report indicates that Sony BMG's "earnings increased slightly on a like-for-like basis" in 2007. CO Trial Ex. 213 at 68. Although revenues and operating profit were down overall, "this was primarily as a result of the sale of the BMG Music Publishing unit," and earnings increased slightly from 2006 when "[a]djusted for the earnings attributable to BMG Music Publishing in the previous year." *Id.*

446. As Ms. Murphy noted, EMI's performance has been uneven. H. Murphy WDT (CO Trial Ex. 15) at 18. EMI had a ██████████ in 2001, saw ██████████ in 2002 and 2003 ██████████, experienced ██████████ in 2004 and 2005 to ██████, and then had ██████████ in 2006. *Id.* at 18-19. There are a number of reasons for EMI's recent stumbles, including mismanagement, excessive spending on artists and high return costs.

447. Terra Firma, a U.K. private equity firm that bought EMI in 2007, believes that "EMI's revenue has declined over the past 5 years due to the shift in the consumer music market and a slow response—by the industry as well as the company—to the growth in digital consumption," and has characterized EMI's assets as "poorly managed." RIAA Trial Ex. 9 at 4032291. Mr. Munns, former Chairman and CEO of EMI North America, corroborated that view with candid trial testimony. 2/26/08 Tr. at 4749-50 (Munns). He conceded, for example, that when he arrived at EMI in the fall of 2001, "the company was a mess," in large part because spending was out of control. *Id.* When asked, Mr. Munns agreed that his predecessors at EMI had managed the business badly, spending too much money on advances, artist signings and marketing. *Id.* at 4750.

448. Further, EMI's market share has fallen dramatically in the past two years, from double digits to a mere 6% in the U.S., and a significant part of its decline in profitability relates to its decline in market share, as Mr. Finkelstein admitted. 2/13/08 Tr. at 3157-58 (C. Finkelstein). Mr. Finkelstein also acknowledged that EMI's profitability over the past few years had been impacted by the fact that EMI's return rates on physical product had been higher than any other return rates he had ever seen in the music business. *Id.* at 3174.

449. Faced with this mountain of evidence of profitability, the RIAA presented new numbers in the rebuttal phase of this proceeding. Mr. Benson reworked the numbers presented by Ms. McLaughlin based on his review of her work and "new" information provided to him by the RIAA. Benson WRT (RIAA Trial Ex. 82) at 6, Appendix A; 5/8/08 Tr. at 5524-30 (Benson). This analysis led Mr. Benson to conclude that Ms. McLaughlin had overstated record company profitability. *See id.* In addition, he claimed that the higher margins on the majors' digital music sales were likely to erode and would "perhaps become negative." Benson WRT (RIAA Trial Ex. 82) at 5. Mr. Benson's testimony is entitled to little weight for several key reasons.

450. The principal adjustments made by Mr. Benson to Ms. McLaughlin's work (which itself had been subject to numerous corrections between the time of her written direct testimony and trial, *see* 2/13/08 Tr. at 3001-13, 3015-22 (McLaughlin)) arose out of "new" financial data obtained from Universal subsequent to Ms. McLaughlin's testimony. According to Mr. Benson, in the period between the direct and rebuttal phases of this proceeding, Universal discovered substantial errors in its 2004 and

2005 financial data relied upon by Ms. McLaughlin. Benson WRT (RIAA Trial Ex. 82) at 34.

451. These errors led Mr. Benson to make approximately [REDACTED] million in adjustments to Ms. McLaughlin's work for 2004 and 2005. Based on these errors, Mr. Benson also made an additional [REDACTED] in "adjustments" to Universal's manufacturing and distribution costs for 1999-2003. Mr. Benson, who never spoke with anyone at Universal, had no understanding as to why Universal had financial information for 2004 and 2005 that was materially different from the information that Ms. McLaughlin had sworn to be true. Nor did he consult with anyone at Universal concerning his decision to restate [REDACTED] in costs for 1999-2003. Benson WRT (RIAA Trial Ex. 82) at 32-33; 5/8/08 Tr. at 5524-29, 5536-39 (Benson).

452. As a result, Mr. Benson added *\$1 billion dollars* to the expenses for the major record companies that Ms. McLaughlin had reported for the years 1999-2005. 5/8/08 Tr. at 5528 (Benson). [REDACTED]

[REDACTED]
[REDACTED] *Id.*

453. Mr. Benson used the aggregate financial data for the U.S. majors described above as a starting point for his attempt to estimate the record companies' profitability by format. *Id.* at 5492-93. Mr. Benson admitted however, in performing his analysis, he did not rely on records maintained in the ordinary course of business by the major record labels that showed profitability by format. Nor did he speak to any financial officer of any major label to confirm that he had reached accurate results. 5/8/08 Tr. at 5518, 5604-5605 (Benson). Finally, Mr. Benson acknowledged that his report presented

financial information only for the majors, and that he had no information with respect to the costs, revenues or profitability of any of the independent recorded music companies, which further limits the utility of his conclusions. *Id.* at 5565-72.

454. The financial results for the major recorded music companies presented in Mr. Benson's report are further flawed because nowhere in his analysis of revenues and costs did he take into account the financial results of the majors' distribution companies. 5/8/08 Tr. at 5555 (Benson). This decision skewed Mr. Benson's results by hundreds of millions of dollars, as the Copyright Owners revealed during cross-examination of Mr. Benson concerning Universal's P&L statements for 2004-2006. *Id.* at 5553-63; *see also* CO Trial Ex. 264. According to Mr. Benson, the revised Universal financial information that he obtained demonstrated that Universal had a profit of [REDACTED], a profit of [REDACTED]. But the financial statements generated by Universal in the ordinary course of business that included [REDACTED] [REDACTED] [REDACTED] CO Trial Ex. 264; 5/8/08 Tr. at 5555 (Benson).

455. In any event, even under Mr. Benson's analysis, profit margins for digital product are twice as high as profit margins for physical product, as he acknowledged during his testimony. *Id.* at 5604.

456. And the same trend found in Ms. McLaughlin's financial data appears in Mr. Benson's data—a return to profitability for the major record companies. Figure 1 in Mr. Benson's rebuttal report presents operating profits and operating margins for the major record companies for the time period 1999-2006. Benson WRT (RIAA Ex. 82) at

8 (Figure 1). That figure shows declining profits and margins from 1999-2003 (with negative profits in 2003), and then a dramatic return to profitability. *See id.* According to Mr. Benson's data, operating profits for the majors were \$405 million in 2004 and \$500 million in 2005, and operating margins were 7.0% in 2004 and 8.5% in 2005. *See id.* Thus, 2004 and 2005 were the most profitable years reported in Figure 1 in Mr. Benson's report. And although this figure shows a decline in operating profits and margin from 2005 to 2006, the 2006 operating profits and margin remain significantly above the 2001-2003 operating profits and margin and are not far below the 1999 and 2000 numbers—and would be far higher had Mr. Benson used reliable numbers. *See id.*

X. The Current Financial Condition of the Permanent Download Industry

A. Revenue

457. As described in detail above, the widespread popularity of permanent download services has translated into strong and growing revenue figures for this segment of the digital music market, which reached \$878 million in 2006. Enders WDT (CO Trial Ex. 10) at 23 n.46. Apple, in particular, reported substantial growth in revenues from the U.S. iTunes Store during the period 2005-2007, with revenues totaling ██████████ in 2005, ██████████ in 2006, and about ██████████ in 2007. Enders WDT (CO Trial Ex. 10) at 31; 2/4/08 Tr. at 1189 (Enders); 2/25/08 Tr. at 4294-95 (Cue); *see also* CO Trial Ex. 85.

B. Costs

458. Digital music providers, including services that offer permanent downloads, incur the following categories of expenses: “the costs of licensing content from record companies and music publishers; the costs of maintaining a network of servers to store digital music files; the bandwidth costs of delivering music to customers;

the costs of selling to customers, including marketing costs, professional and legal fees, and credit card fees; general administrative costs; and certain research and development (R&D) costs related to the storefront.” Enders WDT (CO Trial Ex. 10) at 44.

459. Content-licensing expenses are the most substantial costs faced by companies in the permanent download business, which must obtain licenses for both sound recording rights and mechanical rights. 2/25/08 Tr. at 4258 (Cue). Sound recording royalty costs are dramatically higher than mechanical royalty costs. Enders WDT (CO Trial Ex. 10) at 44; 2/4/08 Tr. at 1223. In 2006, Apple paid approximately █% of revenues generated by the U.S. iTunes Store to the record companies for the use of their sound recordings, paying only approximately █% to music publishers for the use of their musical compositions. Enders WDT (CO Trial Ex. 10) at 48.

460. Apple’s costs incurred by its iTunes Store are set forth below:

Table 10-C: Distribution of iTunes U.S. Music Store Costs, 2003-H1 2007

Calendar Year	2003	2004	2005	2006	H1 2007
iTunes music revenue (m)	████	████	████	████	████
Minus costs (m):					
Content licensing	████	████	████	████	████
- Record company	████	████	████	████	████
- Copyright owners	████	████	████	████	████
Akamai bandwidth & storage	████	████	████	████	████
Total Other costs of goods sold (OCOGS)	████	████	████	████	████
Operating expenses:					
- Credit card fees (m)	████	████	████	████	████
- Marketing	████	████	████	████	████
- Other	████	████	████	████	████
Total operating expenses	████	████	████	████	████
Equals:					
Contribution margin (m)	████	████	████	████	████
Share of revenue:					
Content licensing costs	████	████	████	████	████
- Record company	████	████	████	████	████
- Copyright owners	████	████	████	████	████
Akamai bandwidth & storage	████	████	████	████	████
Total OCOGS	████	████	████	████	████
- Credit card fees	████	████	████	████	████
- Marketing	████	████	████	████	████
- Other	████	████	████	████	████
Total operating expenses	████	████	████	████	████
Contribution margin	████	████	████	████	████

Note: iTunes music revenue excludes the revenue from sales of iPod accessories that are also sold on the storefront and included in Apple’s SEC filings under the category of music revenues.

[Source: Enders Analysis based on Apple disclosure, Apple, iTunes P&L at DiMA 3816-3826. Enders WDT (CO Trial Ex. 10) at 49.]

C. Profitability

461. Notwithstanding its costs (and leaving to one side Apple’s profit margin of over 20% on the sale of iPods), the sale of permanent downloads by Apple has proven to be a profitable enterprise. Enders WDT (CO Trial Ex. 10) at 29; *see also* H. Murphy WDT (CO Trial Ex. 15) at 23.

462. In fact, despite Apple’s claim that its philosophy is to run the iTunes Store just above break-even, the sale of digital music through the iTunes Store has consistently generated a █████—and steadily increasing—“contribution margin” or revenue share:

Table 7-C: iTunes U.S. Music Revenue and Contribution Margin, 2003-H1 2007

Calendar year	2003	2004	2005	2006	H1 2007
Songs (includes songs sold within albums)	██████████	██████████	██████████	██████████	██████████
Revenue	██████████	██████████	██████████	██████████	██████████
Standard margin	██████████	██████████	██████████	██████████	██████████
Standard margin (%)	██████████	██████████	██████████	██████████	██████████
Gross margin	██████████	██████████	██████████	██████████	██████████
Gross margin (%)	██████████	██████████	██████████	██████████	██████████
Contribution margin	██████████	██████████	██████████	██████████	██████████
Contribution margin (%)	██████████	██████████	██████████	██████████	██████████

[Source: Enders Analysis based on Apple disclosure, iTunes P&L at DiMA 3816-3826, attached as Exhibit COA 461. Enders WDT (CO Trial Ex. 31).]

463. The full year 2007 continued the trend, as the iTunes Store’s profits landed “██████████.” 2/25/08 Tr. at 4295 (Cue); *see also* CO Trial Ex. 85.

464. In view of the healthy profit margin earned by Apple on iTunes, Ms. Enders projected iTunes music store revenues, costs and margins, if the Copyright Owners’ proposed rate for permanent downloads is adopted. Enders WDT (CO Trial Ex. 10) at 49-50.

465. Under the assumption that iTunes maintains its current content licensing regime for the period through 2012, without changing the levels of record company remuneration or its existing price points, and thereby having the record companies bear the cost of increased mechanical royalty rates, the contribution margin of iTunes will rise in line with revenue growth as set forth below:

Table 10-D: Forecasts for iTunes under a stable content licensing regime, 2007-2012

Calendar Year	2007e*	2008e	2009e	2010e	2011e	2012e
Revenue (m)	██████	██████	██████	██████	██████	██████
Content licensing costs (m)	██████	██████	██████	██████	██████	██████
Total OCOGS (m)	██████	██████	██████	██████	██████	██████
Total operating expenses (m)	██████	██████	██████	██████	██████	██████
Contribution margin (m)	██████	██████	██████	██████	██████	██████
Contribution margin %	██████	██████	██████	██████	██████	██████

*Data for the first half of 2007 is supplied by Apple, and the second half of 2007 is an estimate of Enders Analysis.

[Source: Enders Analysis based on Apple disclosure, Apple, iTunes P&L at DiMA 3816-3826. Enders WDT (CO Trial Ex. 10) at 50.]

Enders WDT (CO Trial Ex. 10) at 50.

466. Ms. Enders also projected the results if Apple and the record companies agree to assign entirely to iTunes the increase in the mechanical royalty rate that would result should the Copyright Owners' rate proposal for permanent downloads be accepted.

In this scenario, iTunes would absorb the increased royalty rates while the record companies would maintain their current content licensing income levels of around █████% of retail. Enders WDT (CO Trial Ex. 10) at 50-51. Under such circumstances, Apple would still enjoy a healthy contribution margin:

Table 10-E: Forecasts for iTunes under iTunes full absorption of rate increase, 2007-2012

Calendar Year	2007e*	2008e	2009e	2010e	2011e	2012e
Revenue (m)	██████	██████	██████	██████	██████	██████
Content licensing costs (m)	██████	██████	██████	██████	██████	██████
Total OCOGS (m)	██████	██████	██████	██████	██████	██████
Total operating expenses (m)	██████	██████	██████	██████	██████	██████
Contribution margin (m)	██████	██████	██████	██████	██████	██████
Contribution margin %	██████	██████	██████	██████	██████	██████

*Data for the first half of 2007 is supplied by Apple, and the second half of 2007 is an estimate of Enders Analysis.

[Source: Enders Analysis based on Apple disclosure, Apple, iTunes P&L at DiMA 3816-3826. Enders WDT (CO Trial Ex. 10) at 51.]

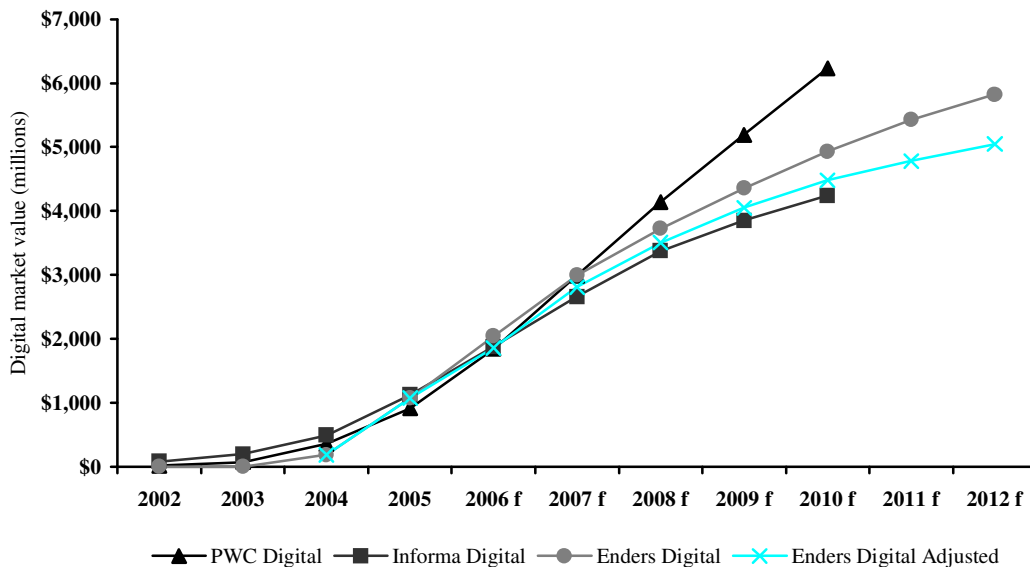
XI. Forecasts for the Recorded Music Industry

467. Numerous publicly available market forecasts for the recorded music industry project the digital market to grow rapidly over the next several years. Enders WDT (CO Trial Ex. 10) at 22; H. Murphy WDT (CO Trial Ex. 15) at 30.

468. According to Ms. Enders, digital sales are expected to rise to an estimated \$5 billion by 2012. Enders WDT (CO Trial Ex. 10) at 22. By all accounts, the growth of the digital music business and the resulting increased profit margins of digital music will have a positive effect on industry revenues and profit margins. H. Murphy WDT (CO Trial Ex. 15) at 31.

469. The graph below illustrates the growth of digital music revenues as forecast by Enders Analysis, PricewaterhouseCoopers and Informa in November 2006, as well as an updated forecast by Enders Analysis, which was adjusted in 2007.

Table 11-Amended: U.S. Digital Music Download Forecasts, 2006-2012



[Source: Enders Analysis 2006 estimates are adjusted in 2007 for information disclosed in discovery; PricewaterhouseCoopers *Global Entertainment and Media Outlook*; Informa *Digital Home Entertainment: Future Consumer Spending Habits*]
Enders WDT (CO Trial Ex. 10) at 58.

470. In particular, forecasts for the rate period predict continued strong growth in the permanent download market. Thus, by 2012 digital singles are predicted to generate roughly \$1.5 billion in revenue and digital albums roughly \$1.2 billion, for a total permanent download market of \$2.7 billion. Enders WDT (CO Trial Ex. 10) Ex. C at 4. As Ms. Enders testified, her forecast is entirely consistent with other public forecasts for the U.S. market that she has had the opportunity to review. 2/4/08 Tr. at 1277-79 (Enders).

471. Given the current strong consumer preference for Apple's iTunes and iPod ecosystem, it is likely that Apple will continue to dominate the digital market. Indeed, Apple is forecasting roughly [REDACTED] in revenues and [REDACTED] in profits from the sale of music for fiscal year 2008. 2/25/08 Tr. at 4298 (Cue); *see also* CO Trial Ex. 86.

472. Mobile music sales in the U.S. are forecasted to reach an estimated \$1.8 billion by 2012, of which \$1.4 billion will be from the sale of ringtones, with the remainder from the sale of mobile full tracks. *See* Enders WDT (CO Trial Ex. 10) at 16, 25-26, 56-57, Ex. C at 5-6; *see also* 2/4/08 Tr. at 1266-74.

473. As a result of the strength of increasing digital sales, record companies, themselves, are projecting significant growth. Murphy WDT (CO Trial Ex. 15), CO Ex. 8A; RIAA Trial Ex. 9.

474. Terra Firma, the U.K. private equity firm that bought the EMI Group in 2007, projects that the total revenues for EMI's worldwide recorded music business will increase at a CAGR of 6.1% from 2007-2012 and that EBITDA will increase at a CAGR of 54.1% during the same period. RIAA Trial Ex. 9 at CO4032305. According to Terra Firma's projections, this revenue growth and increased profitability will flow from

reductions in fixed and variable costs and a revamped digital strategy in which EMI will develop new routes to digital consumers. *Id.* at CO4032300-01.

475. And Mr. Finkelstein, EMI's CFO, testified that the current chairman of the EMI Group, Guy Hands, has projected enormous growth in the profitability of EMI worldwide. *Id.* at 3164; *see also* RIAA Trial Ex. 9. Further, Mr. Finkelstein agreed that it was EMI's view that, because digital margins are higher than physical margins, the company's profitability would grow as the digital business grows. 2/13/08 Tr. at 3165 (C. Finkelstein).

476. Sony BMG projections for 2008 and 2009 also forecast improving profitability and margins on a worldwide basis. Specifically, in 2007 Sony BMG projected that its net income would [REDACTED] in 2007 to [REDACTED] in 2008 and [REDACTED] in 2009, which reflects [REDACTED] respectively. Murphy WDT (CO Trial Ex. 15), CO Ex. 8A at RIAA 14991.

477. Finally, Warner provided revenue forecasts for the next five years that show a CAGR of [REDACTED] for U.S. recorded music revenues. Murphy WDT (CO Trial Ex. 15), CO Ex. 8A at RIAA 39185.

478. Finally, in stark contrast to the record companies' internal forecasts for future profitability based on growth in the digital market, Mr. Benson claimed in his report that digital albums are currently unprofitable for the record companies, and that because sales of digital albums "are growing faster than sales of digital singles, losses on the sales of digital albums will increasingly offset the profits of digital singles." Benson WRT (RIAA Trial Ex. 82) at 5. Based on this analysis, Mr. Benson prepared a profitability forecast for the record music business that predicted that for CDs, digital

singles and digital albums combined, there would be “a total loss of \$393 million by 2011.” *Id.* at 30.

479. Mr. Benson’s profitability forecast for the recorded music industry is flawed for two key reasons. First, it depends on the assumption that distribution costs for digital singles are 10% of revenue (or even higher), which, as shown above, is inconsistent with Mr. Benson’s white paper and record company evidence such as EMI’s digital P&L. 5/8/08 Tr. at 5590, 5595.

480. Second, although Mr. Benson’s profitability forecast relies on projected unit sales from a research report by Veronis Shuler Stevenson (“VSS”), he left out of his analysis that VSS had predicted that billions of dollars in mobile digital music sales (ringtones and mobile downloads) would occur over the next few years. In fact, VSS projected that 20 to 30 percent of the market would be mobile downloads by 2011. Mr. Benson admitted that his analysis applied to only CDs, digital singles and digital albums, and further conceded that he had not provided a complete forecast of the U.S. recorded music business. 5/8/08 Tr. at 5601-5603.

XII. Marketplace Benchmarks Support the Copyright Owners’ Rate Proposal

A. Overview

481. The Copyright Owners’ principal economic expert in both the direct and rebuttal phases of this proceeding, Professor William Landes, identified several benchmarks supporting the mechanical royalty rates sought by the Copyright Owners in this proceeding. Landes WDT (CO Trial Ex. 22) at 22-26. These benchmarks are rooted in competitive markets in which users of music acquire the right to use the copyright to both sound recordings and the musical compositions that have been recorded. *Id.* at 22-23. The benchmarks involve transactions that are uninfluenced by the Section 115

statutory rate and provide information on the remuneration that copyright owners of musical compositions receive when they are able to license their works in the absence of a compulsory license. *Id.*

482. Applying a set of clearly-defined criteria, Professor Landes identified two principal market benchmarks in which copyright users obtain the rights to both sound recordings and the underlying song—the mastertone market and the synchronization license market—that he used to derive a “range of reasonableness” for appropriate mechanical royalty rates. Landes WRT (CO Trial Ex. 406) at 28-29. He further found that the Audio Home Recording Act, 17 U.S.C. §§ 1001-1010 (2008), which divides royalties from the sale of certain digital recording devices between the copyright owners of musical compositions and sound recordings, provided additional corroboration for his range of reasonableness. *Id.* at 29.

483. Professor Landes’s analysis of these market benchmarks demonstrates that reasonable royalties for the Copyright Owners should fall within a range of approximately 20 to 50% of the total license fees paid for the musical composition and the sound recording. Landes WDT (CO Trial Ex. 22) at 25-26. Professor Landes refers to the sum of these license fees as the “content pool.” *Id.*

484. Professor Landes’s benchmarks demonstrate that the Copyright Owners’ proposed rates are all reasonable and at the low end of his range of reasonableness. Accordingly, as discussed in the Copyright Owners’ Proposed Conclusions of Law, Professor Landes concluded that the Copyright Owners’ proposed rates are all consistent with a sound economic interpretation of the four statutory factors contained in Section 801(b) of the Copyright Act.

B. Professor Landes's Criteria for Selecting Benchmarks

485. Professor Landes applied rigorous criteria to identify market benchmarks that demonstrate the value of musical compositions subject to the Section 115 compulsory license when rights to those compositions are negotiated in the absence of a statutory ceiling. Landes WDT (CO Trial Ex. 22) at 22-25.

486. First, Professor Landes explained that the most probative benchmarks arise from voluntary market transactions. *Id.* at 22-23. These transactions provide critical information regarding market participants' willingness to buy and sell. *Id.* at 22. As Professor Landes explained, "economists view benchmarks that arise in voluntary transactions in competitive markets as the best way of valuing products and services, including intellectual property such as music." Landes WRT (CO Trial Ex. 406) at 28. Prices that are the result of voluntary market transactions tend to promote economic efficiency. 2/7/08 Tr. at 2078 (Landes). Competitive prices also provide incentives for the creation of new works, take account of the returns that both buyers and sellers expect to receive from the transaction, and reflect differential costs that the parties to the transaction may have. *Id.* at 2169-71; *see also* Landes WDT (CO Trial Ex. 22) at 19.

487. Second, it is critical that benchmarks be unaffected by a statutory license, such as Section 115, or any other price control. Landes WDT (CO Trial Ex. 22) at 22-23. The goal in identifying appropriate benchmarks is, as Professor Landes explained, to "discover rates that are the result of interactions between buyers and sellers and not the product of a statutory rate." 2/7/08 Tr. at 2080 (Landes). Benchmarks that fall within Section 115, or that are influenced by the statutory license, clearly fail this test and are of limited (if any) value when setting a rate for the Section 115 license itself. *See id.*; *see also infra* Section XV.B.3.

488. Because the rights at issue in this proceeding involve the distribution of musical compositions embedded in sound recordings, an appropriate benchmark provides information regarding the *relative* valuation of the musical composition and sound recording when both rights are free from the constraint of a statutory license. *See* Landes WDT (CO Trial Ex. 22) at 23, 25; *see also* Landes WRT (CO Trial Ex. 406) at 28-29; 2/7/08 Tr. at 2078-80, 2083-84 (Landes). Professor Landes’s benchmarks focus on the relative valuation that buyers in the relevant markets place on the musical composition vis-à-vis the sound recording. As Professor Landes testified, “[e]ven though the absolute value of prerecorded music may differ across uses, the division of total content value between the sound recording (or master) and the publisher (which together supply the ‘content pool’) provides information about the reasonable mechanical royalty rate when rights to the sound recording are negotiated freely but the right to the mechanical is subject to compulsory licensing and rate setting.” Landes WDT (CO Trial Ex. 22) at 25.

489. Finally, Professor Landes sought benchmarks that require users to acquire separate licenses for both the copyrighted musical composition and the sound recording. *Id.*; *see also* Landes WRT (CO Trial Ex. 406) at 28-29; 2/7/08 Tr. at 2079-80 (Landes). Such benchmarks allowed Professor Landes to assess the relative values that the marketplace ascribes to compositions and their sound recordings.

C. Professor Landes’s Benchmarks

490. Professor Landes identified two freely-negotiated market rates that allowed him to determine the relative valuation of the musical composition and the sound recording: (1) licenses for mastertones and (2) licenses for synchronization rights. *See* Landes WDT (CO Trial Ex. 22) at 23-25; *see also* Landes WRT (CO Trial Ex. 406) at 28-29; 2/7/08 Tr. at 2081-2104 (Landes). Professor Landes’s third benchmark, from the

Audio Home Recording Act, provides corroboration of the relative value of the rights to musical compositions and sound recordings through the statute's division of royalties from the sale of digital audio recorders. *See* Landes WDT (CO Trial Ex. 22) at 24; *see also* Landes WRT (CO Trial Ex. 406) at 29, 32; 2/7/08 Tr. at 2105-07 (Landes).

1. The Mastertone Benchmark

491. Based on an examination of numerous voluntary marketplace agreements for the licensing of mastertones, Professor Landes found that the Copyright Owners typically acquire 20% of the total amount paid for compositions and sound recordings in the mastertone market. Landes WDT (CO Trial Ex. 22) at 24-25; *see also* 2/7/08 Tr. at 2091-2104 (Landes); Landes WRT (CO Trial Ex. 406) at 36; 5/20/08 Tr. at 7519-20 (Landes).

(a) The Ringtone and Mastertone Market

492. As described in Section II.B, the category of products referred to generally as ringtones includes monophonic ringtones, which contain only a single melodic line; polyphonic ringtones, which contain both melody and harmony; and mastertones, which are derived from digital sound recordings. Mastertone sellers must acquire rights to both the musical composition and the sound recording. Landes WDT (CO Trial Ex. 22) at 24. As discussed in the Copyright Owners' Proposed Conclusions of Law, a decision by the Register of Copyrights in late 2006 for the first time held that ringtones were subject to the Section 115 compulsory license, *see* Ringtones Opinion. The vast majority of the ringtone and mastertone licenses reviewed by Professor Landes predated the Ringtones Opinion. Landes WDT (CO Trial Ex. 22) at 46.

493. Publishers have licensed the rights to their musical compositions for use in mastertones: (1) directly to aggregators or “third-party sellers”; or (2) directly to record companies. *See infra* XII.C.1.a.i; XII.C.1.a.ii.

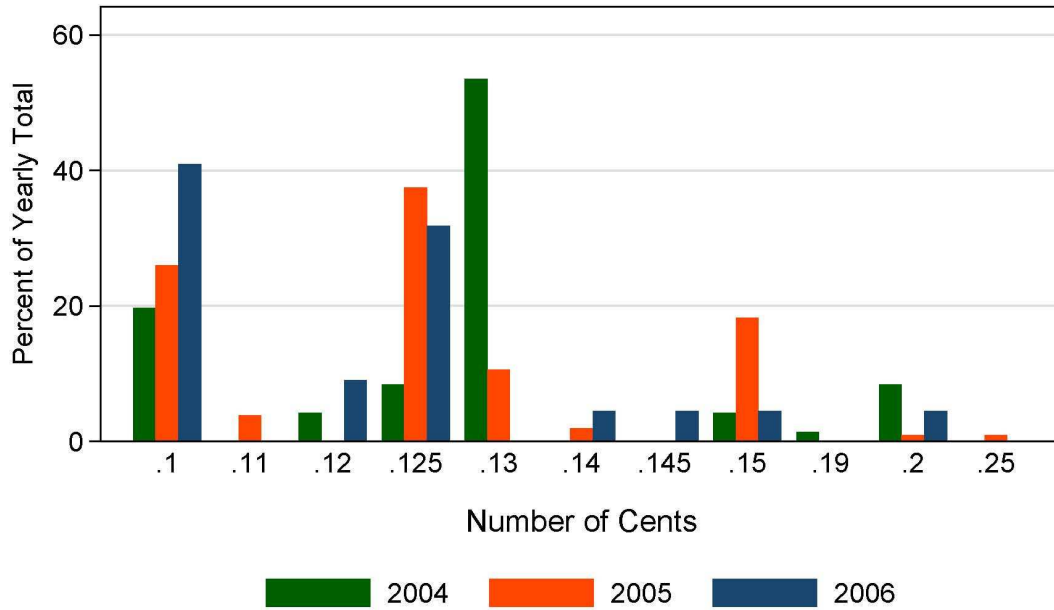
(i) Agreements with Third-Party Sellers

494. In mastertone licenses between Copyright Owners and third-party sellers of ringtones (either aggregators or cellular telephone companies), the license fee typically is a tiered structure providing for payment at the greater of (1) a specified per-mastertone penny minimum, (2) a percentage of the retail price of the mastertones, and/or (3) a percentage of gross revenue. *See, e.g.*, Faxon WDT (CO Trial Ex. 3), CO Ex. 218; Robinson WDT (CO Trial Ex. 8), CO Exs. 101-110, 112-119; Israelite WDT (CO Trial Ex. 11), CO Exs. 17-22; Peer WDT (CO Trial Ex. 13), CO Exs. 152, 156, 160, 161; Firth WDT (CO Trial Ex. 24), CO Exs. 252, 298, 328, 329, 351.⁹ Professor Landes reviewed and relied upon nearly 200 such agreements from six different music publishers spanning the years 2004, 2005, and 2006 in his analysis. Landes WDT (CO Trial Ex. 22) at 40; *see also* Faxon WDT (CO Trial Ex. 3), CO Ex. 218; Robinson WDT (CO Trial Ex. 8), CO Exs. 101-110, 112-119; Israelite WDT (CO Trial Ex. 11), CO Exs. 17-22; Peer WDT (CO Trial Ex. 13), CO Exs. 152, 156, 160, 161; Firth WDT (CO Trial Ex. 24), CO Exs. 252, 298, 328, 329, 351.

495. The penny rates in the reviewed agreements ranged from 10 to 25 cents, with an average of 12.5 cents. Landes WDT (CO Trial Ex. 22) at 41. The figure below from Professor Landes’s Written Direct Testimony demonstrates the distribution of these rates.

⁹ A small minority of these agreements—eleven out of nearly 200—contained only penny rates. *See* CO Trial Ex. 11, Exs. 28, 29, 34, 36-39, 40, 42-44.

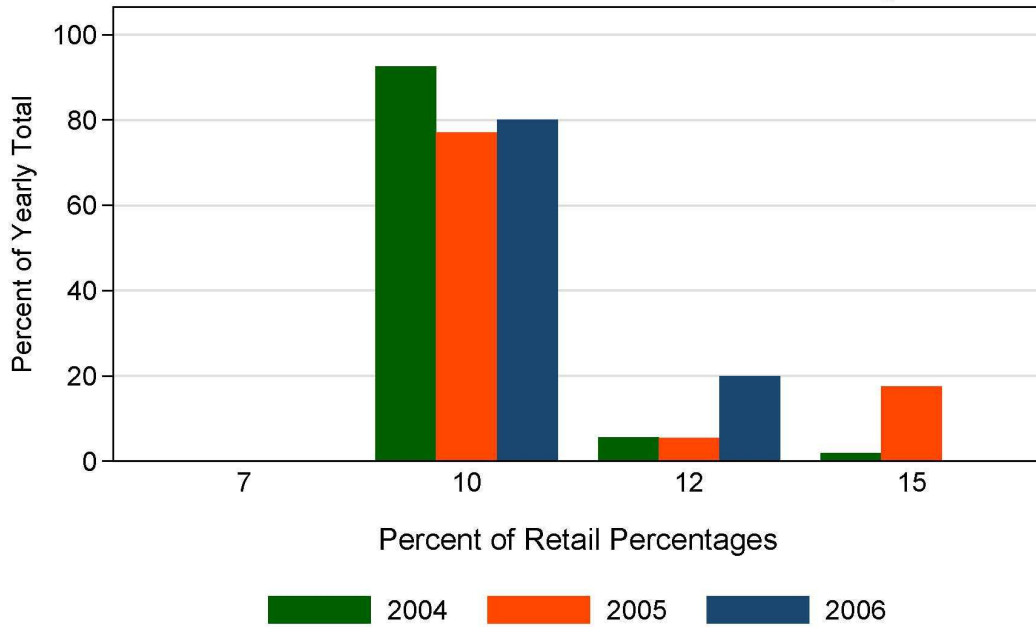
Figure 8
Distribution of MasterTone Minimums
(Number of Cents)



Source: License Agreements provided by Publishers.

496. The retail price percentages ranged from 10 to 15%, with an average of 10.5%. *Id.* at 41. The figure below, from Professor Landes's Written Direct Testimony, illustrates the distribution of these rates.

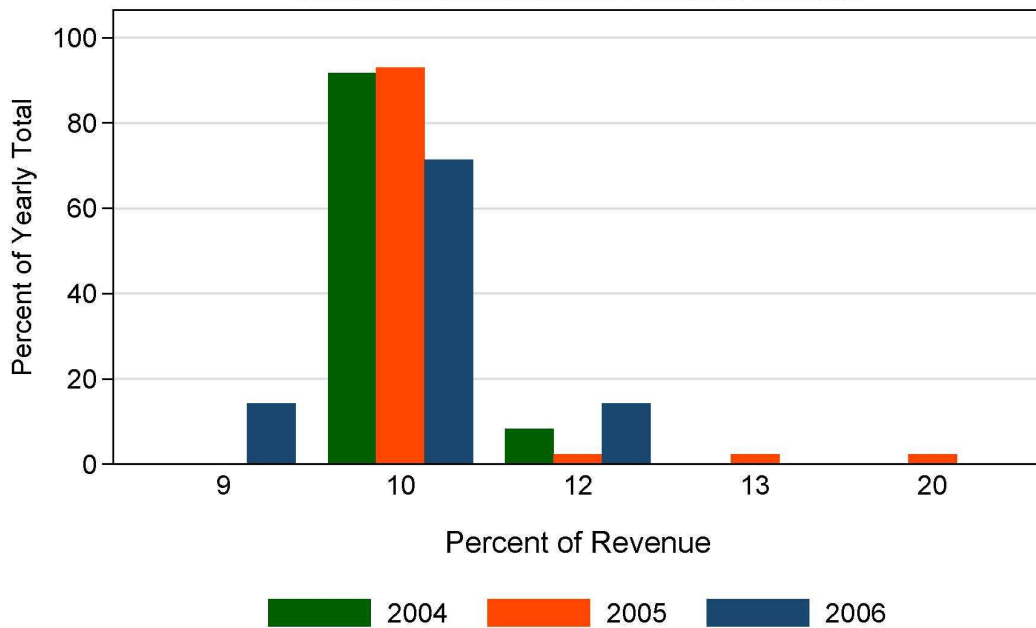
Figure 9
Distribution of MasterTone Percent of Retail Percentages



Source: License Agreements provided by Publishers.

497. Finally, the gross revenue percentages ranged from 9 to 20%:

Figure 10
Distribution of MasterTone Percent of Revenue



Source: License Agreements provided by Publishers.

(ii) Agreements with Record Companies

498. Music publishers have also licensed record companies to sell mastertones themselves or for sale by a third-party ringtone seller. These agreements have taken the form of either so-called “New Digital Media Agreements” (“NDMAs”) or “standalone” licenses for mastertones only.

499. Beginning in November 2004, several music publishers entered into NDMAs with major record companies that covered, among other rights, the licensing of musical compositions for use in mastertones. *See, e.g.*, Firth WDT (CO Trial Ex. 3), CO Exs. 219-221; Firth WDT (CO Trial Ex. 24), CO Ex. 332; *see also* Landes WDT (CO Trial Ex. 22), Ex. B at 30 (identifying additional NDMAs, reviewed by Professor Landes, between Sony BMG and Warner-Chappell Music Publishing, and between Sony BMG and Famous Music Publishing).

500. The NDMAs specified a tiered royalty rate for mastertones. Landes WDT (CO Trial Ex. 22) at 25 n. 13. Record companies agreed to pay a fee equal to the greater of \$0.10, 10% of the retail price or 20% of the wholesale price for each mastertone sold. *Id.*

501. As Professor Landes testified, the rates in the NDMAs were consistent with prior licensing activity in the mastertone market. *See* Landes WRT (CO Trial Ex. 406) at 36; 5/20/08 Tr. at 7519-20 (Landes); *see also* Landes WDT (CO Trial Ex. 22), Ex. B at 5, 29 (listing the relevant agreements in evidence as documents reviewed by Professor Landes). Prior to November 2004, sellers of mastertones paid music publishers the greater of \$0.15 and 10% of retail revenue per mastertone. *See* Faxon WDT (CO Trial Ex. 3), Ex. 218, Ringtone and Mastertone License with Ampay at 5, Ringtone and Mastertone License with Lagardere at 5, Mastertone License with Opera Telecom at 5.

Record companies entered into agreements with third-party mastertone sellers prior to the execution of the first NDMA in November of 2004 that provided them with the greater of 50% of retail revenue or \$1.00 per mastertone. *See, e.g.,* [REDACTED]. These agreements included “pass-through” licenses requiring the record companies to acquire (and pay for) licenses for the underlying compositions. *See* CO Trial Ex. 413 at 5; CO Trial Ex. 415 at 4.

502. Standalone mastertone licenses that postdate the NDMA have identical rates as those contained in the NDMA. *See* Israelite WDT (CO Trial Ex. 11), [REDACTED]; CO Trial Ex. 13, [REDACTED]. This was true even though these agreements did not grant any rights for multi-session audio products (such as DualDisc), locked content, or digital video.

503. To date, mastertones have typically been sold at retail prices of \$1.99 or more. *See* Landes WDT (CO Trial Ex. 22) at 47; Enders WDT (CO Trial Ex. 10) at 42-43. As a result, music publishers have been paid on a percentage of revenue rather than penny basis. *See* Landes WDT (CO Trial Ex. 22) at 41 (calculating average payments to publishers for mastertone rights of 16 to 25 cents); Wildman WRT (RIAA Trial Ex. 87) at 51 (identifying mechanical royalties for mastertones as 24.6 cents per mastertone).

(b) The Copyright Owners’ Share of the Content Pool

504. Based on his analysis of mastertone licenses, Professor Landes concluded that the Copyright Owners’ share of the content pool for the licensing of mastertones was typically 20%. Landes WDT (CO Trial Ex. 22) at 24-25; *see also* 2/7/08 Tr. at 2091-2104 (Landes).

505. First, the NDMAAs all provide that publishers receive, at a minimum, 20% of the licensing fees paid by mastertone sellers to record companies for the licensing of the sound recording inclusive of the right to the musical composition. *See* Landes WDT (CO Trial Ex. 22) at 25 n.13; *see also* Faxon WDT (CO Trial Ex. 3), CO Ex. 219 at 15, CO Ex. 220 at 24, CO Ex. 221 Ex. A at 22; Firth WDT (CO Trial Ex. 24), CO Ex. 332 at 19.

506. Second, the mastertone rates in the NDMAAs are consistent with standalone mastertone agreements between publishers and third-party ringtone sellers, on the one hand, and record companies and third-party ringtone sellers, on the other. Landes WRT (CO Ex. 406) at 36. This conclusion is based on a simple inference from the rates in these sets of agreements. *See* 5/20/08 Tr. at 7520 (Landes). Professor Landes's analysis of approximately 200 mastertone agreements revealed an average retail percentage payable to publishers of 10.5% (calculated from those 143 agreements containing percent-of-retail minima). *See* Landes WDT (CO Trial Ex. 22) at 41 (providing average percent-of-retail royalty rate); *id.* at Figure 9 (illustrating the distribution of percent-of-retail minima); 2/7/08 Tr. at 2131 (Landes) (identifying the number of agreements in Figure 9).

507. For their part, the record companies typically receive the greater of 50% of retail or \$1.00 when licensing their sound recordings for use as mastertones, and they have done so while undertaking the obligation to acquire and pay for publishing royalties out of their licensing revenue. Landes WDT (CO Trial Ex. 22) at 46-47. The relationship between this licensing activity—with record companies usually receiving 50% of retail revenue for their licenses (inclusive of the obligation to acquire licenses for

the underlying compositions), and with publishers receiving (on average) 10.5% of retail revenue—implies a value of the rights to musical compositions of slightly over 20% of the licensing fees necessary to sell mastertones.

(c) The RIAA’s Counterarguments Do Not Undermine the Mastertone Benchmark

508. None of the RIAA’s evidence or arguments undermines the mastertone benchmark.

(i) The Mastertone Market Is Large

509. The RIAA claims that the small size of the mastertone market renders it an inappropriate benchmark. *See, e.g., Wildman WRT (RIAA Trial Ex. 87) at 23.* The evidence is to the contrary. *See, e.g., Landes WRT (CO Trial Ex. 406) at 32.*

510. First, the number of songs that have earned revenue as mastertones is demonstrably large. In 2006, nearly █████ songs earned mastertone revenue for UMPG. In 2007, that number increased to almost █████. *Landes WRT (CO Trial Ex. 406) at 32-33.* Similarly, in 2006, approximately █████ songs earned ringtone royalties for EMI Music Publishing, accounting for roughly █████ of the songs that earned any royalties that year. *Id.* at 33. In 2006, across the music industry, 262.8 million ringtones were sold. *Enders WDT (CO Trial Ex. 10) at 15.*

511. Second, the mastertone market has been significant in terms of revenue and sales. As the RIAA’s principal rebuttal economist, Professor Wildman, acknowledged, the mastertone market currently represents the third largest source of revenue for record companies. *5/12/08 Tr. at 5966 (Wildman).* In 2006, across the U.S. music industry, ringtone sales generated \$1.04 billion in revenue. *Enders WDT (CO Trial Ex. 10), Ex. C at 6.* That year, Sony BMG alone earned over █████ from the

sale of mastertones, CO Trial Ex. 77 at 2; *see also* 2/20/08 Tr. at 3994 (Wilcox), and in 2007, the company made nearly [REDACTED] from all forms of ringtones, including mastertones, CO Trial Ex. 338 at 2. One witness from the company described mastertones as “a vital component of Sony BMG’s digital business strategy.” Rosen WDT (RIAA Trial Ex. 63) at 5.

512. With respect to music publishers as well, revenues from ringtones and mastertones have been substantial. In 2007, EMI MP earned over [REDACTED] from the sale of mastertones, which constituted nearly [REDACTED] of its total digital revenue. Faxon WRT (CO Trial Ex. 375), Ex. B. That was nearly a threefold increase over the company’s mastertone revenue in 2006. *See id.* For the entire period 2003 to 2007, revenue from ringtones and mastertones accounted for [REDACTED] of the company’s combined income from digital uses. Faxon WRT (CO Trial Ex. 375) at 4. Mr. Faxon expects mastertone revenues to continue to rise. 5/14/08 Tr. at 6365 (Faxon).

513. Although a relatively small number of songs account for the bulk of mastertone revenue, *see* 5/20/08 Tr. at 7378-80 (Landes), the mastertone market is no different from the rest of the recorded music industry. The music industry, generally, is “hit-driven”—the industry depends on a small number of recordings to drive revenues and profits. *See, e.g.*, Teece WDT (RIAA Trial Ex. 64) at 21 (“It is widely recognized that most sound recordings are not profitable”); 5/8/08 Tr. at 5342 (Slottje) (“the likelihood of any given particular song becoming a hit is low”); Kushner WDT (RIAA Trial Ex. 62) at 15 (“only one out of every ten new artists signed to major record labels will have a successful album”).

(ii) Supply and Demand Characteristics of the Mastertone Market Do Not Weaken its Use As a Benchmark

514. The RIAA's rebuttal economists, Professors Wildman and Slottje, also opine that the supply and demand characteristics of the mastertone market undermine its utility as a benchmark. *See* Slottje WRT (RIAA Trial Ex. 81) at 19-20; Wildman WDT (RIAA Trial Ex. 87) at 22-25. Their opinion has no factual support in the record. Nor is there any empirical evidence to support the argument that mastertones primarily serve a social "signaling" function, unlike other uses of recorded music. Slottje WRT (RIAA Trial Ex. 81) at 19; Wildman WRT (RIAA Trial Ex. 87) at 24.

515. Professors Slottje and Wildman claim that the price disparity between permanent downloads (typically sold for \$0.99 each) and mastertones (typically sold for \$1.99 to \$2.50 each) render mastertones an unsuitable benchmark for the remainder of the music market. Slottje WRT (RIAA Trial Ex. 81) at 20; Wildman WRT (RIAA Trial Ex. 87) at 23. As Professor Wildman conceded, however, permanent mobile downloads (*i.e.*, full-track downloads that can be acquired on cellular phones) also sell for a retail price in excess of permanent, non-mobile downloads. 5/12/08 Tr. at 5967-68 (Wildman). Neither Professor Wildman nor Professor Slottje presented any evidence to show that the retail price points for mastertones and permanent downloads are anything other than a function of the premium that consumers place on portability.

516. Nor did either economist give any consideration to the substantial evidence indicating that the price point for permanent downloads was set artificially low to fuel sales of portable music players. Apple's principal concern is driving the sale of its portable music player, the iPod, as well as its brand of personal computers. *See* CO Trial Ex. 88 at 12 (Apple CFO explaining that the iTunes store is run with relatively low

margins “because we think that selling music and now videos, helps us to sell iPods and accessories”); CO Trial Ex. 89 at 10 (Apple CFO explaining that the iTunes store is run with relatively low margins because “it helps us to sell iPods and Macs and that is really our strategy”); [REDACTED]

[REDACTED]; *see also* Enders WDT (CO Trial Ex. 10) at 29-30 (discussing relationship between iTunes and other Apple products).

517. Professor Wildman also claims that because there is “an antecedent event (the sales performance of a sound recording)” to the sale of a mastertone, consumer demand is “much more predictable than for the sound recordings from which they are taken.” Wildman WRT (CO Trial Ex. 87) at 23. The RIAA has provided no evidence, however, to show that anything relating to consumer demand for mastertones influences the division of revenues paid for both the recording and the underlying composition.

**(iii) Professor Wildman’s Bargaining Theory
Deserves No Weight**

518. Professor Wildman also opines that economic bargaining theory undermines the utility of the mastertone benchmark. Wildman WRT (RIAA Trial Ex. 87) at 29. Professor Wildman claims that the “shares of surplus” that copyright owners and record companies receive in the mastertone market would “differ systematically from the shares that would be determined by upfront negotiations over all surplus because the substantial costs of producing, promoting and distributing recordings would influence bargaining over total surplus across all uses of sound recordings.” *Id.* This theory is advanced without any empirical support. 5/12/08 Tr. at 5935-37 (Wildman). Nor has a

single one of the 11 record company executives who testified at trial offered any facts to support Professor Wildman's theory.

519. Professor Wildman also appears to argue that record companies accepted a smaller share of the content pool paid for mastertones because the costs of producing the sound recordings had already been sunk at the time of creation of the mastertones.

Wildman WRT (RIAA Trial Ex. 87) at 29. As described in the Copyright Owners' Proposed Conclusions of Law, this argument has been twice addressed—and rejected—by this Court at the urging of the record companies which now sponsor it. Indeed, when a similar argument was made in the 2001 Webcasting proceeding, Professor Wildman, in his role as an expert witness for the RIAA, testified that it “flies in the face of economic theory.” 5/12/08 Tr. at 5948; *see also id.* at 5947-48 (Wildman).

(iv) The Preexisting Monophonic and Polyphonic Ringtone Market Did Not Inflate Mastertone Rates

520. Professor Wildman also asserted, without any foundation, that the rates obtained by publishers in the NDMAAs could be explained by their “credible threat to refuse to license mastertone rights and continue to earn profits instead by selling ringtones only.” Wildman WRT (RIAA Trial Ex. 87) at 20. He claimed that, as a result, music publishers would have “demanded a higher price to compensate them.” *Id.* at 19. The record does not support the argument.

521. As Professor Wildman himself concedes, “a complete analysis” of this opportunity cost would be “complex, involving potential growth in the marketplace, the cross-elasticity of demand between the two products, and the possibility that unit sales increased due to the introduction of mastertones.” Wildman WRT (CO Trial Ex. 87) at 20. He performed no such analysis.

522. In fact, he testified that it was entirely possible that publishers would have accepted a lower royalty rate for mastertones than for monophonic and polyphonic ringtones. *See* 5/12/08 Tr. at 5970-72 (Wildman). Professor Wildman acknowledged that the publishers were interested in maximizing revenue, not the rate. *See id.* If they could have earned more money from licensing mastertones at half the monophonic or polyphonic rate, they would have done so. *Id.* at 5970.

(v) The Bundling of Rights in the NDMAs Did Not Inflate Mastertone Rates

523. The RIAA's argument that the mastertone rates should be dismissed as the product of trade-offs concerning other rights that were part of the NDMAs, *see, e.g.*, Wilcox WDT (RIAA Trial Ex. 70) at 27; A. Finkelstein WDT (RIAA Trial Ex. 61) at 13, is contrary to the weight of the evidence.

524. As Professor Landes explained, if, "as the record companies claim, they conceded to the publishers' demands on the mastertone rates recited in the NDMAs in order to obtain favorable terms for the other rights licensed in those agreements, economic theory predicts that the publishers would have been able to extract *more* favorable mastertone terms than were contained in the standalone agreements." Landes WRT (CO Trial Ex. 406) at 37. In fact, the mastertone rates in the NDMAs are consistent with earlier licensing activity. *See id.; supra* XII.C.1.a; XII.c.1.b..

525. The RIAA also asserted, through the testimony of Mr. Wilcox, that the record companies were induced to pay above-market mastertone rates in order to obtain only a single mechanical royalty for DualDiscs. Wilcox WDT (RIAA Trial Ex. 70) at 28. Although Mr. Wilcox testified that such an agreement was necessary to launch the product, the evidence shows that DualDiscs were first released by Sony BMG in spring

2004, six months or more before the first NDMA was signed in November 2004. 2/20/08 Tr. at 3977 (Wilcox).

526. The RIAA has also sought to dismiss the NDMA as experimental, short-term agreements. Wilcox WDT (RIAA Trial Ex. 70) at 27. In fact, three of the major record companies have extended the terms of the NDMA. Faxon WRT (CO Trial Ex. 375) at 6-7, Ex. C.

527. Sony BMG entered into an extension of its NDMA with EMI MP in March 2007—well after the DualDisc had failed. *See id.* at 6; *see also* 2/14/08 Tr. at 3406 (A. Finkelstein) (“[DualDisc] was never a commercially successful product.”). That extension provided for a continuation of the same mastertone rates—[REDACTED]—through June 30, 2008. *See* CO Trial Ex. 73 at 2; Faxon WDT (CO Trial Ex. 3), CO Ex. 219 at 14-15. And, in stark contrast to the [REDACTED] in revenue generated by mastertones in 2006, CO Trial Ex. 77 at 2; *see also* 2/20/08 Tr. at 3994 (Wilcox), DualDisc had generated much less—only [REDACTED]—over the same time period, CO Trial Ex. 77 at 1.

528. Similarly, two other record companies agreed to extend their NDMA with EMI MP in 2007, at a time when it was apparent that DualDisc had failed commercially. *See* Faxon WRT (CO Trial Ex. 375) at 6-7; *see also* CO Trial Ex. 375, Ex. C. Universal agreed to extend through December 31, 2008 at [REDACTED]. Faxon WRT (CO Trial Ex. 375) at 6; CO Trial Ex. 375, Ex. C at 6. Warner Music Group agreed to extend through August 31, 2008 at [REDACTED]. Faxon WRT (CO Trial Ex. 375) at 7; CO Trial Ex. 375, Ex. C at 11. [REDACTED]

[REDACTED]. Faxon WRT
(CO Trial Ex. 375) at 7; CO Trial Ex. 375, Ex. C at 11.

(vi) The Mastertone Market Is Not a Transient One

529. The RIAA's experts have also claimed that this Court should not give much weight to the mastertone benchmark because the mastertone market "was understood to be fleeting." Slottje WRT (RIAA Trial Ex. 81) at 21; *see also* Wildman WRT (RIAA Trial Ex. 87) at 17-18. The evidence is to the contrary: In June 2005, shortly after the execution of the NDMA's, music publishers predicted that the U.S. ringtone market would grow to be a billion dollar market by 2008. Wildman WRT (RIAA Trial Ex. 87), Ex. 103-RR at 7.

530. The RIAA also argues that, whatever the predictions for the mastertone market when the NDMA's were signed, mastertones will be "obsolete in the near future." Slottje WRT (RIAA Trial Ex. 81) at 21. Again, the empirical evidence refutes the RIAA's claim. The forecast presented by Claire Enders, the Copyright Owners' expert on the state of the digital music industry, projects further increases in the US ringtone market through 2012, when it will amount to nearly \$1.5 billion in revenue. Enders WRT (CO Trial Ex. 10), Ex. C at 6. Enders's analysis is corroborated by the testimony of Mr. Faxon, who expects revenue from mastertone sales to continue to rise. 5/14/08 Tr. at 6365 (Faxon).

2. The Synchronization Benchmark

531. Professor Landes's second benchmark is derived from the market for synchronization licenses. Landes WRT (CO Trial Ex. 22) at 23-24. The evidence from this market reveals that the Copyright Owners typically receive one-half of the total

licensing fees paid by licensees who wish to use a sound recording in an audiovisual work. *Id.*

(a) Publishers and Record Companies Receive Equivalent Fees in the Synchronization Market

532. In order to use a sound recording in an audiovisual work such as a movie, television show or commercial, licensees must obtain a “synchronization” (or “synch”) license for the underlying musical composition, as well as a “master use” license for the sound recording. Landes WDT (CO Trial Ex. 22) at 23; *see also* Pascucci WRT (RIAA Trial Ex. 80) at 3; 2/7/08 Tr. at 2081-82 (Landes); 5/7/08 Tr. at 5292-5293 (Pascucci). Both rights are unconstrained by a compulsory license. Landes WDT (CO Trial Ex. 22) at 23; *see also* 2/7/08 Tr. at 2082 (Landes).

533. The market for synchronization licenses is competitive. *See* 2/7/08 Tr. at 2081-83 (Landes). As RIAA witness Scott Pascucci explained, synchronization licensing is a high volume business. *See* Pascucci WRT (RIAA Trial Ex. 80) at 4. In 2007, his company, which handles all master use licensing for Warner Music, “received approximately 10,000 license requests, of which, approximately 2,500 resulted in completed and paid master use licenses.” *Id.* Industry-wide, there are tens of thousands of synchronization transactions completed each year, and there is competition between songs and between recordings for use in synchronization. *See* 5/7/08 Tr. at 5288-89 (Pascucci).

534. Copyright owners of musical compositions and sound recordings typically receive equivalent licensing fees. Landes WDT (CO Trial Ex. 22) at 24. Indeed, most favored nation provisions, included both in licenses between licensees and publishers and between licensees and record companies, have made the receipt of equivalent licensing

fees a standard practice. *Id.* at 24; *see also* Faxon WDT (CO Trial Ex. 3) at 38; 5/7/08 Tr. at 5291 (Pascucci). Under these provisions, if a licensee acquires one of the two necessary rights, and subsequently agrees to pay the other licensor a greater fee than it paid the first, the licensee is obligated to retroactively increase the fee paid to the first party. Landes WDT (CO Trial Ex. 22) at 24; *see also* Faxon WDT (CO Trial Ex. 3) at 38; 5/7/08 Tr. at 5291 (Pascucci); Firth WDT (CO Trial Ex. 24), CO Ex. 251 at 2-3, CO Ex. 254 at 4, CO Ex. 277 at 3-4, CO Ex. 361 at 4-5.

535. Based on his investigation of the market, Professor Landes determined that the fees paid for the rights to musical compositions (*i.e.*, synchronization rights) and sound recordings (*i.e.*, master use rights) are typically equivalent. Landes WDT (CO Trial Ex. 22) at 23. Thus, in the vast majority of transactions, the publisher and record company each receive 50% of the fees paid for the content pool. *Id.* at 23-24; *see also* Faxon WDT (CO Trial Ex. 3) at 38; 2/7/08 Tr. at 2084 (Landes); 2/12/08 Tr. at 2650 (Firth); 5/7/08 Tr. at 5289-92, 5300 (Pascucci).

(b) The RIAA’s Counterarguments Do Not Undermine the Synchronization Benchmark

536. None of the RIAA’s arguments designed to undermine the synchronization benchmark is supported by the record.

(i) Professor Wildman’s Bargaining Theory Is Baseless

537. As with the mastertone benchmark, Professor Wildman argues that the division in fees between publishers and record companies in the synchronization market is explained by the fact that “the negotiation for synchronization royalties occurs at a point in time when the original production and marketing costs have already been incurred (if not recovered).” Wildman WRT (RIAA Trial Ex. 87) at 16. Once again, the

RIAA's rebuttal economist offered his opinion without the benefit of any empirical study. 5/12/08 Tr. at 5937 (Wildman). Not a single record company witness offered any evidence that record companies would do anything less than seek to maximize their share of synchronization revenue. To the contrary, Mr. Pascucci, the record company witness called on rebuttal expressly to attempt to rebut the utility of the synchronization benchmark, explained that when his company negotiates master use licenses, its "[p]rimary goal is maximizing revenue." 5/7/08 Tr. at 5277 (Pascucci).

**(ii) Competitive Pressures Affect Both
Synchronization and Master Use License
Transactions**

538. The RIAA also fails in its attempt to explain the equal division of license fees in the synchronization market on the ground that prospective synchronization licensees have access to multiple recordings of a song, or can re-record (or "cover") a song rather than acquire rights to a particular, existing sound recording. Wildman WRT (RIAA Trial Ex. 87) at 13; Pascucci WRT (RIAA Trial Ex. 80) at 4. As Mr. Pascucci acknowledged, there is a symmetry of competitive pressures on both the side of the recording and the composition: Synchronization licensees can choose among many different songs and many different recordings and can substitute one for another. 5/7/08 Tr. at 5293-95 (Pascucci). And as Professor Landes explained, "[f]ew songs are so unique that a commercial or movie can use only that song to convey a particular message." Landes WRT (CO Trial Ex. 406) at 31. Just as a potential master use licensee can produce a cover recording, it can avoid the need for a synchronization license by creating a new musical composition through a work-for-hire arrangement. 2/11/08 Tr. at 2457-58 (Landes).

539. The RIAA's argument is unsupported by any empirical data demonstrating that licensees prefer to record cover versions to acquiring the rights to existing master recordings. Landes WRT (CO Trial Ex. 406) at 31-32. In fact, producing a cover version "is in itself a costly enterprise" that serves to reduce licensees' incentives to pursue that course. *Id.* at 32.

(iii) The RIAA's Product Usage Arguments Are Unsupported

540. The RIAA also asserts that the nature of the synchronization benchmark should be disregarded because sound recordings are just one of a variety of inputs when synchronized into a film, television show or commercial. Wildman WRT (RIAA Trial Ex. 87) at 14; Pascucci WRT (RIAA Trial Ex. 80) at 4. Again, the RIAA's argument is devoid of any empirical evidence to suggest that this affects the value of the sound recording more than it does the value of the musical composition. As a result, there is no evidence that the placement of a song in an audiovisual work has any impact on the relative value of the rights or the equal division of payments between the composition and the recording.

3. The Audio Home Recording Act Benchmark

541. Professor Landes's third benchmark is the Audio Home Recording Act of 1992 ("AHRA"), 17 U.S.C. §§ 1001-1010 (2008), a law that provides royalties from the sale of digital recording devices to the copyright owners of musical compositions and sound recordings. Landes WDT (CO Trial Ex. 22) at 24. This law was spurred by concerns within the music industry that new digital recording devices would permit consumers to easily make high-quality digital copies of music, adversely affecting the market for audio recordings. *Id.* The AHRA provides that royalties collected from the

sale of specified digital recording devices are split one-third for the “Musical Works Fund” and two-thirds for the “Sound Recording Fund.” *Id.* Thus, under the AHRA, owners of musical compositions receive one-third of the content pool. *Id.*

542. Professor Landes explained that although the AHRA “is not strictly the result of a voluntary exchange in a competitive market, it reflects the outcome of a compromise among competing interest groups in the legislative context and thus provides evidence of the relative value of copyrighted songs and sound recordings.” Landes WRT (CO Trial Ex. 406) at 29; *see also* Landes WDT (CO Trial Ex. 22) at 24. Professor Landes testified that inferences from such legislation are backed up by “economic analysis of law,” and “an enormous amount of scholarly work on the legislative process.” 2/7/08 Tr. at 2106 (Landes). Moreover, the royalty division embodied in the AHRA was determined through a voluntary agreement among the relevant rights holders, which was subsequently incorporated into the legislation by Congress. Landes WRT (CO Trial Ex. 406) at 32.

D. The Copyright Owners’ Proposed Rates Fall at the Low End of Professor Landes’s Range of Reasonableness

543. Based on his review of the large volume of free-market transactions in the mastertone market and synchronization rights market, as well as the corroboration provided by the division of royalties in the AHRA, Professor Landes determined that copyright owners of musical compositions receive 20 to 50% of the content pool—*i.e.*, the total amount paid by licensees for the rights to both compositions and sound recordings—when unconstrained by a compulsory license. Landes WDT (CO Trial Ex. 22) at 23. Thus, Professor Landes concluded that this represents the “range of

reasonableness” for the Section 115 mechanical license royalty rate. Landes WRT (CO Trial Ex. 406) at 29.

544. Mindful of the breadth of this range, Professor Landes explained that the highest rates implied by the range might lead to a disruptive impact in the music industry. See 2/7/08 Tr. at 2114, 2254 (Landes); 2/11/08 Tr. at 2345 (Landes). That possibility, he added, must be balanced against the incentive effects of an appropriately high statutory rate and the fact that the statutory rate acts as an effective ceiling on the mechanical royalty rates that copyright owners receive for their works. See 2/7/08 Tr. at 2114 (Landes); see also Section XIII.D.

545. Professor Landes’s analysis of the Copyright Owners’ proposed rates demonstrated that they are not only within the range of reasonableness established by freely-negotiated market rates, but at the low end of that range. Landes WDT (CO Trial Ex. 22) at 49; Landes WRT (CO Trial Ex. 406) at 22.

1. Physical Phonorecords

546. Professor Landes found that the Copyright Owners’ proposal for physical products would provide the copyright owners of musical compositions with no more than 24% of the content pool. Landes WDT (CO Trial Ex. 22) at 33. Professor Landes reached this figure by applying the Copyright Owners’ proposed rate to information on revenues and costs used by the RIAA’s own experts. *Id.*

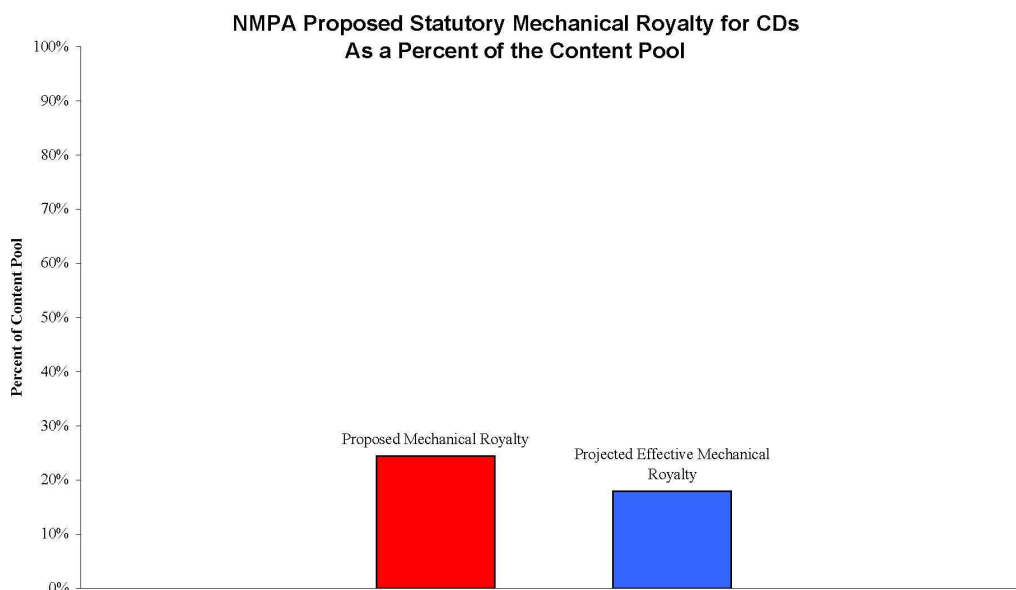
547. Specifically, Professor Landes took wholesale revenues for physical products reported by record companies for 2005, the most recent year available at the time, and deducted manufacturing and distribution costs to identify a content pool for physical products. *Id.*; see also 2/7/08 Tr. at 2163-68 (Landes). These deductions are appropriate because manufacturing and distribution costs are primarily attributable to

physical products. 2/7/08 Tr. at 2164 (Landes). Using this content pool, Professor Landes then assumed that the Copyright Owners' proposed rate—12.5 cents—would apply to all tracks on physical products without any possibility for negotiation below the statutory rate. Landes WDT (CO Trial Ex. 22) at 33. Under this assumption and using the RIAA's own data, Professor Landes found that the Copyright Owners' proposal would result in the allocation of 24% of the content pool to musical compositions sold on physical products. *Id.*; *see also* 2/7/08 Tr. at 2162-68 (Landes).

548. Professor Landes also adjusted his calculation to account for negotiations that have historically occurred below the statutory rate—*i.e.*, the difference between the statutory rate and the “effective rate.” Landes WDT (CO Trial Ex. 22) at 33. Once again using the record companies' own data, Professor Landes found that the Copyright Owners' proposal, when taking into account the prevalence of discounting in the most recent year available, would likely result in mechanical royalty payments representing 18% rather than 24% of the content pool. *Id.*

549. The figure below, from Professor Landes's Written Direct Testimony, presented the results of his analysis.

Figure 5a



550. Based on these calculations, Professor Landes found the Copyright Owners’ proposed statutory rate for physical products to be “well within the range of reasonableness” derived from his benchmarks. Landes WDT (CO Trial Ex. 22) at 34; *see also* 2/7/08 Tr. at 2168 (Landes).

2. Permanent Downloads

551. Professor Landes similarly concluded that the Copyright Owners’ proposal for permanent downloads—15 cents per track sold—fell at the bottom of his range of reasonableness. 2/7/08 Tr. at 2178-79 (Landes); *see also* Landes WDT (CO Trial Ex. 22) at 36-41.

552. To evaluate the proposal, Professor Landes divided the proposed mechanical royalty rate of 15 cents by 70 cents, the amount that record companies typically receive per track when licensing sound recordings for sale as individual downloads. Landes WDT (CO Trial Ex. 22) at 36; *see also* 2/7/08 Tr. at 2178 (Landes). Doing so, Professor Landes found that the Copyright Owners’ proposal would result in

the allocation of approximately 21% of the content pool for permanent downloads to the musical composition. 2/7/08 Tr. at 2178-79 (Landes); *see also* Landes WDT (CO Trial Ex. 22) at 36-37.

553. Professor Landes also explained that because record companies are compensated differently for the sale of sound recordings as albums (typically at \$7.00 per album), the content pool calculation would differ slightly for albums. 2/11/08 Tr. at 2478-79 (Landes). Revenues from the sale of singles account for the bulk of revenues that record companies receive from the permanent download market. *See* Landes WDT (CO Trial Ex. 22) at 38-39. Still, assuming 13 tracks per album (the average tracks-per-album figure used by the RIAA), the Copyright Owners' proposal would result in the allocation of only 28% of the content pool to musical compositions for digital albums. 2/11/08 Tr. at 2478-79 (Landes).

3. Ringtones

554. Professor Landes found that the Copyright Owners' proposed set of rates for ringtones fell within his range of reasonableness. Landes WDT (CO Trial Ex. 22) at 48. Professor Landes reached this conclusion both through application of his range of reasonableness and by reference to free-market ringtone licensing activity that occurred prior to the decision from the Register of Copyrights subjecting ringtones to the compulsory license. *See id.* at 45-48.

555. Knowing that record companies typically receive the greater of 50% of retail revenue or \$1.00 for every mastertone sold, and that they receive this remuneration with the obligation to pay for mechanical licenses, Professor Landes directly compared two of the Copyright Owners' proposed tiers—15% of retail revenue or 15 cents—and concluded that each allocated less than one-third of the content pool to the musical

composition. *See* 2/7/08 Tr. at 2211-12 (Landes); *see also* Landes WDT (CO Trial Ex. 22) at 48. The third tier of the Copyright Owners' proposal, which would ensure them one-third of the content pool for mastertones, also fell well within Professor Landes's range of reasonableness. 2/7/08 Tr. at 2212 (Landes).

556. Professor Landes relied upon licensing activity in the mastertone market as an additional justification for the Copyright Owners' proposed ringtone rates. *See* 2/7/08 Tr. at 2212-16 (Landes). Prior to the Register's decision, publishers had received a range of penny and retail percentage rates, so that although the Copyright Owners' proposed rates were higher than the average negotiated rates, this was justifiable given the range of bargaining he had seen and the ability of parties to negotiate rates below a statutory rate. *See* 2/7/08 Tr. at 2212-16; *see also* Landes WDT (CO Trial Ex. 22) at Figure 8, Figure 9.

XIII. The Statutory Rate is an Effective Ceiling on the Mechanical Royalty Rate

557. The evidence in the record before this Court establishes that the statutory rate acts as a *de facto* ceiling on the mechanical royalty rates that copyright owners can negotiate when engaging in voluntary licensing outside the procedures of Section 115. *See, e.g.,* Landes WDT (CO Trial Ex. 22) at 12; Landes WRT (CO Trial Ex. 406) at 38-39. Parties are free, however, to bargain below the statutory rate, and such negotiations are facilitated by the relatively low transactions costs in the market. *See* Landes WDT (CO Trial Ex. 22) at 12-15. Given these facts, setting the mechanical royalty rate too low would effectively truncate the compensation to songwriters and publishers. Landes WRT (CO Trial Ex. 406) at 39. Robust empirical evidence from HFA, which represents the majority of the mechanical licensing market, demonstrates that discounting below the statutory rate has decreased over time. Landes WDT (CO Trial Ex. 22) at 28-32, 39-40;

Landes WRT (CO Trial Ex. 406) at 33-34. This suggests that the current statutory rate is below the rate one would see in a competitive market unfettered by a compulsory license. Landes WDT (CO Trial Ex. 22) at 28-32, 39-40; Landes WRT (CO Trial Ex. 406) at 33-34.

A. The Statutory Rate Operates as a Cap

558. Economists put forward by both the RIAA and the Copyright Owners agree that the statutory rate acts as a ceiling on the rates that can be negotiated for mechanical rights. According to Professor Landes, “the copyright owners cannot credibly hold out for a fee above the statutory rate, because everyone knows that statutory licenses at statutory rates are available to the record companies.” Landes WRT (CO Trial Ex. 406) at 39. As a result, “[n]o potential user will offer to pay a publisher more for the right to use a composition than he has to pay if he takes a compulsory license.” Landes WDT (CO Trial Ex. 22) at 12.

559. Professor Murphy concurred with this assessment, explaining that because even the “most desirable songs” are available at the statutory rate through the compulsory license, the effect of the statutory rate is to allow bargaining below, but not above, the statutory rate. *See* 5/15/08 Tr. at 6903-06 (K. Murphy).

560. Testimony from the only RIAA economist who opined on this matter is consistent with the assessments of Professor Landes and Professor Murphy. Professor Wildman testified that the statutory rate “impose[s] a cap on what the marketplace might negotiate.” 5/12/08 Tr. at 5900 (Wildman). Indeed, in his own examination of licensing data, *see infra* XV.B.3.c, Professor Wildman found no license rates above the statutory rate, 5/12/08 Tr. at 5830 (Wildman).

561. Fact witnesses called by both the Copyright Owners and the RIAA confirmed the economists' assessment. Andrea Finkelstein of Sony BMG testified that “[b]ecause there is the last resort of a compulsory license (no matter how impractical), publishers and writers almost always license use of any song at a rate no higher than the statutory rate.” A. Finkelstein WDT (RIAA Trial Ex. 61) at 6. In response to the question of what would her company do if faced with a request for a mechanical rate in excess of the statutory rate, she stated: “we would go compulsory if we had to.” 2/14/08 Tr. at 3382 (A. Finkelstein) (cited in Landes WRT (CO Trial Ex. 406) at 39 n.54); *see also* 2/14/08 Tr. at 3328 (A. Finkelstein). Mr. Israelite of HFA likewise explained that “the rate serves as an artificial ceiling on what a songwriter can make.” 2/5/08 Tr. at 1420-21 (Israelite). Songwriter Phil Galdston concurred: “[t]he compulsory rates act as a kind of maximum wage; while we may be paid less than the statutory rate, we are never paid more.” Galdston WDT (CO Trial Ex. 4) at 5.

B. Parties Are Free to Bargain Under the Statutory Rate

562. Ample testimony in the record, from witnesses for both the Copyright Owners and the RIAA, confirms that although parties are effectively precluded as a practical matter from bargaining above the statutory rate, they are free to negotiate below that rate and do so.

563. Publishers often license songs below the statutory rate, even when the songs are not subject to controlled composition clauses, *see supra* IV.C.2.b. Landes WDT (CO Trial Ex. 22) at 12-13, 20, 34-35; *see also* 2/7/08 Tr. at 2141-45 (Landes). Mr. Israelite explained that publishers “can always negotiate under the rate, and it happens all the time.” 2/5/08 Tr. at 1420 (Israelite). Indeed, although the amount of

licensing through HFA below the statutory rate has declined over time, there is still noticeable discounting. *See* Landes WDT (CO Trial Ex. 22) at Figure 4, Figure 5. Mr. Peer testified that his company often provides reduced rates, particularly for low-priced compilation albums. *See* 2/5/08 Tr. at 1666-68 (Peer). Mr. Firth noted that BMG “[f]airly often” licensed below the statutory rate when requested to do so because of the large number of tracks on an album. 2/12/08 Tr. at 2704 (Firth). And Mr. Faxon likewise explained that EMI MP “is quite willing to grant requests for reduced rates” and routinely does so. Faxon WRT (CO Trial Ex. 375) at 15; *see also id.*, Exs. I, J (summarizing gratis licenses and requests for reduced rates). In fact, in 2006, EMI MP agreed to reduced rates for █████ songs, or █████ of the total number of songs for which reduced rate requests had been made. *Id.*, Ex. J. In 2007, the company agreed to reduced rates for █████ songs, which was █████ of the songs for which the company had received requests. *Id.*

564. The testimony from the RIAA supports what witnesses for the Copyright Owners have said. Professor Teece stated in his written report that “record companies sometimes obtain mechanical licenses from music publishers at rates lower than the statutory rate.” Teece WDT (RIAA Trial Ex. 64) at 29. Andrea Finkelstein of Sony BMG likewise acknowledged that her company acquires licenses below the statutory rate. 2/14/08 Tr. at 3380 (A. Finkelstein).

C. Transactions Costs of Negotiating Below the Statutory Rate are Low

565. The ability to negotiate below the statutory rate is facilitated by the relatively low transactions costs of such negotiations. As Professor Landes explained, the most likely sources of transactions costs are inapplicable in mechanical licensing market. Landes WDT (CO Trial Ex. 22) at 14-15. Geographic distance can make negotiations

costly, but “physical proximity is irrelevant since transactions in this industry typically are arranged electronically.” *Id.* at 14. Likewise, identifying the relevant parties is not difficult because HFA “serves as the clearinghouse for the majority of mechanical licenses.” *Id.* And although the existence of large numbers of parties can create coordination problems, “HFA often coordinate[s] licensing between publishers . . . and the record companies.” *Id.*

566. Professor Landes concluded that although there were some transactions costs in this market as in any other, 5/20/08 Tr. at 7472 (Landes) (“[A]ny transaction involves transactions costs. There is nothing that’s costless.”), “transactions costs are not likely to prevent publishers and licensees from negotiating below the statutory rate when the parties would find it mutually beneficial to do so,” Landes WDT (CO Trial Ex. 22) at 14. The ample evidence in the record regarding licensing activity below the statutory rate supports Professor Landes’s analysis. *See supra* XIII.B.

D. Economic Theory Demonstrates The Harm in Setting The Mechanical Royalty Rate Too Low

567. As Professor Landes explained, the dangers involved in setting a rate that exceeds some licensees’ willingness to pay are largely self-correcting in the marketplace. It is in the interests of the mechanical licensor to issue the license below the statutory rate, the low transactions costs in the market will allow the parties to bargain for a reduced rate. Landes WDT (CO Trial Ex. 22) at 16. A rate that is too low, however, will “reduce the financial benefits and hence incentives for composers to take the additional time and effort required to create new songs, even though users would value those songs by more than the cost of creating them and be willing to pay more than the statutory rate.” Landes WRT (CO Trial Ex. 406) at 2. Simply put, a rate that is too low will

discourage the creation of musical works. *Id.*; *see also* Landes WDT (CO Trial Ex. 22) at 16, 27. As Professor Murphy explained, such a rate will “reduce the number of songs being supplied” and “reduce[] the quality of songs that would be supplied.” 5/19/08 Tr. at 6983 (K. Murphy).

568. This does not mean that a rate should be set at an artificial, above-market rate. As Professor Landes explained, this would lead to other problems—namely, the increased transactions costs in the market that would result as large numbers of parties negotiate to an appropriate rate. *See* 2/7/08 Tr. at 2114, 2254 (Landes); 2/11/08 Tr. at 2345 (Landes). The goal, Professor Landes explained, should be to approximate an “average” rate that would be paid by parties in a free market if there were no compulsory license. Landes WDT (CO Trial Ex. 22) at 29; *see also* 2/11/08 Tr. at 2592-97 (Landes). The Copyright Owners’ rate proposal, which is at the lower end of a range of reasonable marketplace alternatives, is consistent with these principles.

E. HFA Licensing Data Supports a Rate Increase for Physical Phonorecords and Permanent Downloads

569. The Copyright Owners’ proposal for a rate increase for physical phonorecords and permanent downloads finds substantial support in empirical work conducted and presented by Professor Landes.

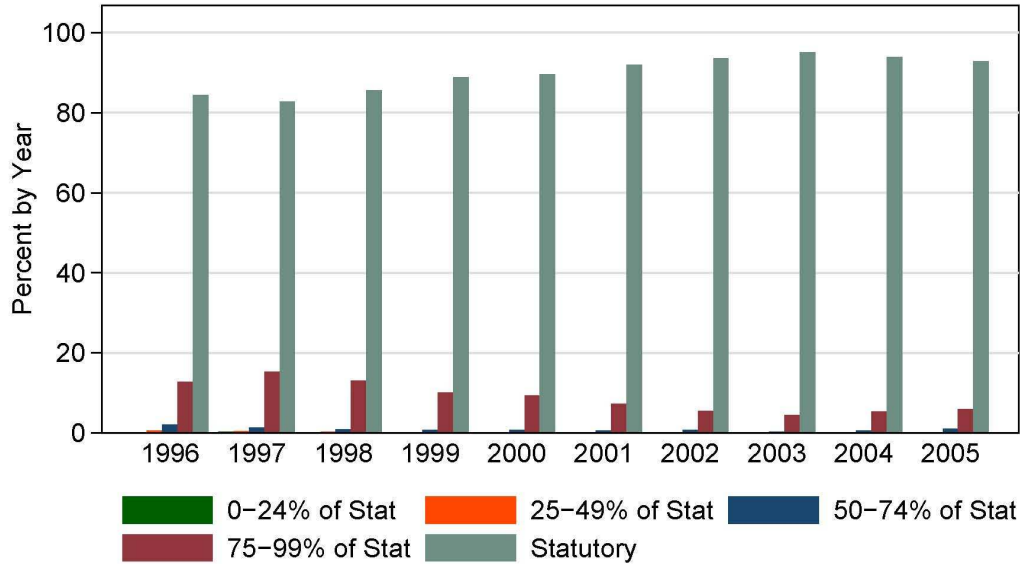
570. Professor Landes testified that in the absence of a statutory rate, an economist would expect to see a distribution of rates set in mechanical licenses. Landes WDT (CO Trial Ex. 22) at 28. The distribution of rates that has occurred in the shadow of the statutory rate provides evidence regarding the appropriateness of the current rate. *Id.* If discounting below the statutory rate were very frequent, that would indicate that the statutory rate is in excess of the average price that would result in a free market. *Id.*

If, on the other hand, discounting were infrequent, that would suggest that the statutory rate is lower than the average rate that would be seen in a competitive market. *Id.*

571. To assess the state of the market, Professor Landes analyzed the fraction of discounting below the statutory rate in the data for HFA's physical and permanent download licenses. Although noting that HFA does not handle all mechanical licensing, Professor Landes found these data probative because of the scale of licensing the agency handles. *Id.* at 30. Mr. Israelite explained that HFA includes "all of the major publishers," as well as "thousands and thousands of smaller publishers," and that HFA covers "the vast majority of the market." *Id.* at 1384-85.

572. In the case of physical recordings not subject to a controlled composition clause, Professor Landes found that the fraction of licenses issued below the statutory rate had been generally declining over the period 1996 to 2005 (the most recent full year for which Professor Landes had data at the time of his written direct testimony). *Id.* at 30; *see also* Figure 4. Specifically, he observed that for the period 1996 to 1998, the percentage of licenses at the statutory rate was between 82 and 85%, but from 2003 on, the comparable figure was approximately 95%. *Id.* at 30. The figure below, from Professor Landes's Written Direct Testimony, reports the results of his analysis.

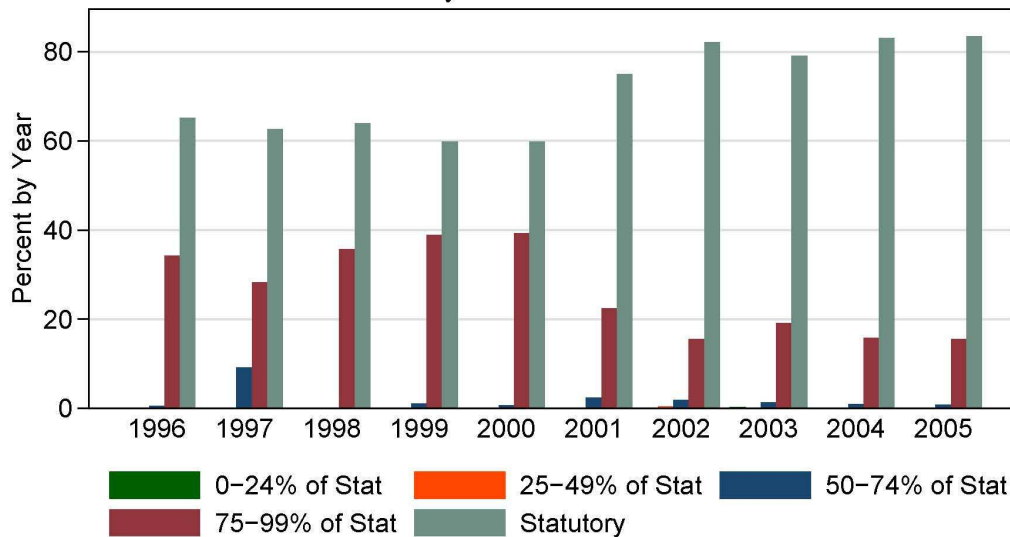
Figure 4
Licenses Issued Each Year by HFA by Rate Category
Physical and NotControlled



Source: HFA Data.
Excludes licenses without rate info or with rate TBD.

573. Professor Landes saw the same declining trend in discounting when he weighted these licenses by the number of units sold. *Id.* at 31, Figure 5. The fraction of sales from songs licensed at the statutory rate rose from approximately 65% in the years 1996 to 2000 to over 80% in 2004 and 2005. *Id.* at 31. The following figure, from Professor Landes’s Written Direct Testimony, illustrates this trend.

Figure 5
 Fraction of Units Sold
 by Percent of Statutory Rate by Distribution Year
 Physical Not Controlled



Source: HFA Data

Note: Based only on data for licenses issued later than 1995 that can be matched to distributions.

574. Based on these data, Professor Landes concluded that “the voluntarily negotiated rate for physical recordings typically would be higher than the statutory rate if rates were not limited by statute,” *id.* at 29, and, as a result, that the remuneration of copyright owners of musical compositions has been truncated, *id.* at 31-32. At the very least, Professor Landes noted, these data do not support a rate decrease. *Id.* at 29.

575. In his rebuttal testimony, Professor Landes performed this analysis including both controlled and non-controlled licenses for physical products. Landes WRT (CO Trial Ex. 406) at 33-34. He reported that the data “show the same pattern” as the data presented in his direct testimony: “whether or not licenses for compositions subject to controlled compositions are included, the fraction of HFA licenses issued at less than the full statutory rate has declined.” *Id.* at 34. This analysis reinforced Professor Landes’s opinion regarding the reasonableness of a mechanical royalty rate

increase. *Id.* Figures 10 and 11 to Professor Landes’s Written Rebuttal Testimony, which presented the results of this expanded analysis, are reproduced below.

Figure 10
Licenses Issued Each Year by HFA by Rate Category
Physical Controlled and Not Controlled

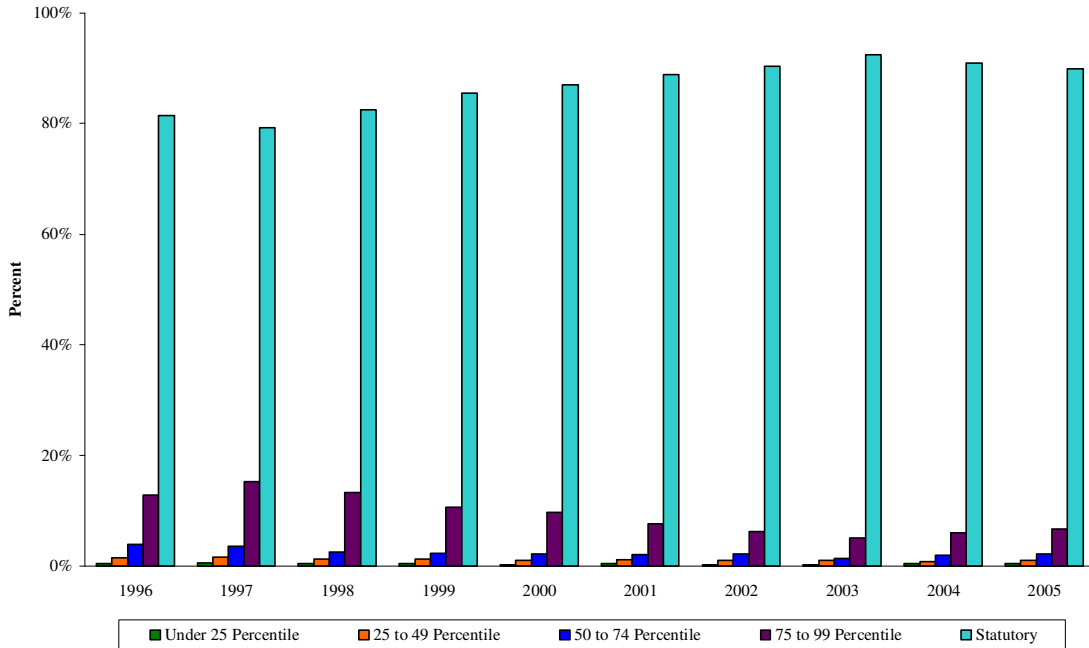
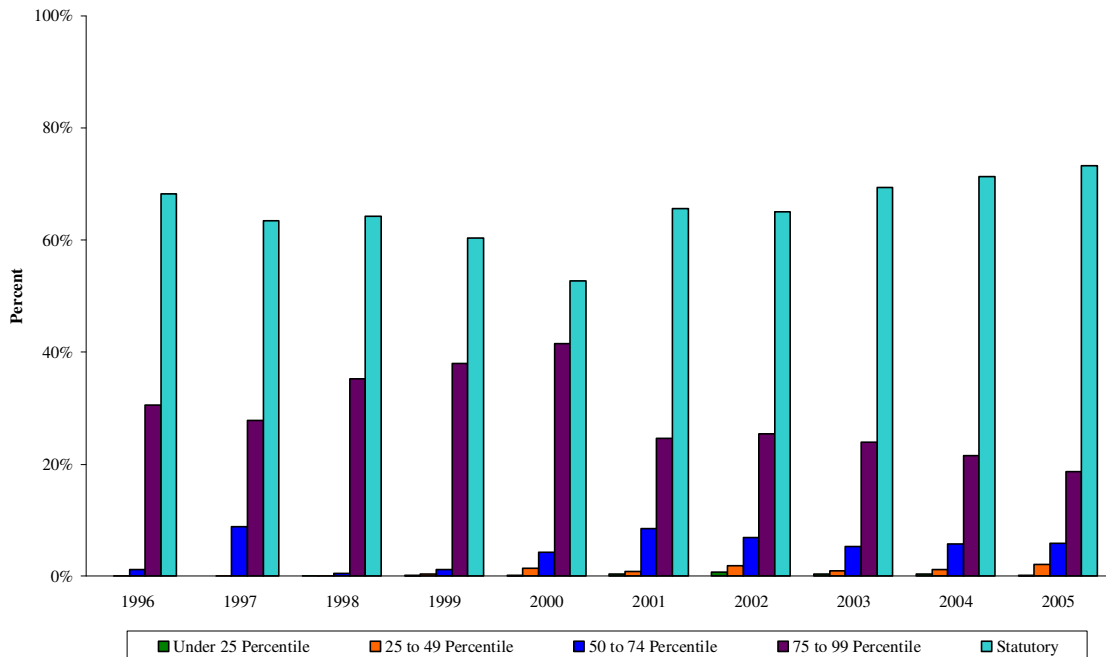


Figure 11
Fraction of Units Sold by Percent of Statutory Rate by Distribution Year
Physical Controlled And Not Controlled



576. Professor Landes likewise analyzed HFA’s licensing data for permanent downloads. He found that “the rate for virtually all permanent downloads of noncontrolled compositions is the full statutory rate.” Landes WDT (CO Trial Ex. 22) at 39; *see also id.* Figure 6, Figure 7. As with the data for physical products, Professor Landes concluded that the statutory rate had acted as a ceiling on the rates that would be negotiated for permanent downloads in the absence of a statutory rate. *Id.* at 39-40.

F. Mr. Alfaro’s Criticisms of Professor Landes’s Analysis of the HFA Licensing Data Are Meritless

577. The RIAA attempted to challenge the HFA licensing study through the testimony of a would-be expert, David Alfaro. *See* Alfaro WRT (RIAA Trial Ex. 77). The record shows that the observations of Mr. Alfaro—whose fact testimony was admitted after the Court denied to qualify him as an expert, 5/6/08 Tr. at 4976-77 (Sledge, C.J.)—did not affect Professor Landes’s work or conclusions in any way.

578. First, Mr. Alfaro claimed that the exclusion of licenses issued under controlled composition clauses altered the results of Professor Landes’s initial study. Alfaro WRT (RIAA Trial Ex. 77) at 6-10. Professor Landes, however, included these licenses in the second study of HFA data he conducted, which was contained in his rebuttal testimony (filed at the same time as Mr. Alfaro’s). Landes WRT (CO Trial Ex. 406) at 33-34. The inclusion of these licenses did not alter the trend Professor Landes observed: Over the course of the ten years covered by the HFA data, a declining fraction of licenses has been issued under the statutory rate. *Id.*; *see also supra* XIII.E.

579. Second, Mr. Alfaro asserted that Professor Landes inappropriately misidentified certain digital licenses as licenses for physical product. Alfaro WRT (RIAA Trial Ex. 77) at 11-12. The brunt of this criticism was that Professor Landes’s

analysis of the degree of discounting in physical licenses was corrupted by the inclusion of digital licenses. Professor Landes addressed and dispensed with the claim: Although certain digital configurations were classified as “physical” in an interim step in his analysis, ultimately all of those licenses were excluded from his study and conclusions. *See* 5/20/08 Tr. at 7396-7401 (Landes). Thus, the suggestion that Professor Landes erroneously included digital licenses in his study of discounting of physical products is “completely incorrect.” *Id.* at 7401.

580. Mr. Alfaro also lodged a series of criticisms about licenses that Professor Landes excluded from his study. Alfaro WRT (RIAA Trial Ex. 77) at 4-6, 10-13. Prior to testifying at trial, he had additional complaints about Professor Landes’s work but was forced to withdraw them because he had committed data processing errors. *See* 5/8/08 Tr. at 4979-85, 5021-30, 5058 (Alfaro).

581. Professor Landes unequivocally rejected Mr. Alfaro’s surviving criticisms, testifying that they did not affect the results of his study in any way. 5/20/08 Tr. at 7514 (Landes). Notably, even Mr. Alfaro himself did not claim that the purported exclusions affected the results of Professor Landes’s analysis: “I don’t have an opinion on what should or should not have been included. I am only reporting on what was excluded and included in his analysis.” 5/6/08 Tr. at 5041 (Alfaro); *see also id.* at 5014-15, 5041, 5053. As a result, Mr. Alfaro’s testimony provides no basis for challenging any aspect of Professor Landes’s work.

XIV. The Statutory Rate Should Remain a Penny Rate for Physical Phonorecords and Permanent Downloads

582. The Copyright Owners have proposed the continuation of the penny rate system for all physical phonorecords and permanent downloads. In the Matter of

Mechanical and Digital Phonorecord Delivery Rate Adjustment Proceeding, *Amended Proposed Rates and Terms of NMPA, SGA and NSAI*, Docket No. 2006-3 CRB DPRA (July 2, 2008). As the Copyright Owners have demonstrated throughout this proceeding, the penny rate—which has been in place for almost a century—has the advantage of being a usage-based metric that is simple to calculate and easy to administer. *See e.g.*, 2/7/08 Tr. at 2173 (Landes). In addition, the penny rate provides critical price protection to the Copyright Owners—indeed, the same type of price protection that record companies insist on when they license sound recordings to digital music services for distribution. *See, e.g.*, CO Trial Ex. 92 at DiMA 3781; CO Trial Ex. 112 at DiMA 10724-10725; 5/13/08 Tr. at 6112 (Eisenberg). The arguments by the RIAA and DiMA in favor of a percentage model, on the other hand, are unsupported by either the record evidence or economic theory.

A. Overview of the Participants’ Rate Proposals

583. The current mechanical royalty rate is calculated on a penny basis. Since January 1, 2006, the rate has been the greater of 9.1 cents per song or 1.75 cents per minute of playing time or fraction thereof.

584. For physical phonorecords, the Copyright Owners have proposed an increase from the current rate to the greater of 12.5 cents per song or 2.40 cents per minute of playing time or fraction thereof, subject to periodic adjustments for inflation, as measured by the CPI (“CPI Adjustments”). Professor Landes concluded that an appropriate Consumer Price Index (“CPI”) to apply to the Copyright Owners’ rate proposal is the “Consumer Price Index-Urban Wage Earners and Clerical Workers” (U.S. Bureau of Labor Statistics Series CWSR0000SA0). As he explained, this CPI “captures

the broadest array of U.S. goods and services.” Landes WRT (CO Trial Ex. 406) at 6 n.5; *see also* 5/19/08 Tr. at 7252-53 (Landes).

585. For permanent downloads, the Copyright Owners have requested an increase from the current rate to the greater of 15 cents per song or 2.90 cents per minute of playing time or fraction thereof, also subject to CPI Adjustments.

586. As discussed more fully below, following the basic structures set forth in existing ringtone agreements entered into by the parties, the Copyright Owners have proposed a rate for ringtones equal to the greatest of: (i) 15 percent of revenue; (ii) one-third of total content costs; or (iii) a penny minimum of 15 cents per ringtone, subject to CPI Adjustments.

587. Both the RIAA and DiMA have proposed abolishing the penny rate and replacing it with a rate based on a percentage of revenue. The RIAA submitted an amended rate proposal in connection with its rebuttal case. The RIAA’s primary rate proposal for both physical products and permanent downloads is 9% of wholesale revenue, and 15% of wholesale revenue for ringtones. RIAA Amended Proposal at 1.

588. Apparently recognizing the merit of the Copyright Owners’ arguments in favor of a penny rate, the RIAA included in its amended rate proposal an “alternative rate proposal including cents rates designed to approximate its percentage rate proposal for certain configurations.” *Id* at 5. The alternative rate request is not the RIAA’s “[p]referred [a]pproach.” *Id*. It includes a variety of different penny rates; for example, for songs sold to digital music services at a wholesale price of 70 cents, it requests a royalty of 6.3 cents per track, and it requests a royalty of 18 cents per ringtone. *Id.* at 5, 6.

589. DiMA, too, submitted an amended rate proposal with its rebuttal case. For permanent downloads, DiMA has proposed a percentage rate coupled with minima for bundled goods and/or services. Specifically, DiMA has requested a mechanical royalty rate payable at “the greater of (i) 6% of applicable receipts or (ii) 4.8 cents per track for single tracks or 3.3 cents per track for tracks sold as part of a single transaction including more than single track (‘bundles’).” In the Matter of Mechanical and Digital Phonorecord Delivery Rate Adjustment Proceeding, *Amended Proposed Rates and Terms of DiMA*, Docket No. 2006-3 CRB DPRA (Apr. 10, 2008) (“DiMA Amended Proposal”), at 4. (DiMA has not proposed rates for physical phonorecords or ringtones.)

B. History of the Penny Rate

590. Since its inception in 1909, the statutory mechanical royalty rate has always been calculated on a penny basis. As described above in Section II.C.1, Congress initially set the mechanical royalty rate at 2 cents per musical work in the Copyright Act of 1909, and the rate remained unchanged for 69 years, until 1978, when, pursuant to the Copyright Act of 1976, it was increased to 2.75 cents per composition. In addition to increasing the mechanical royalty rate, the Copyright Act of 1976 provided for an “overtime” rate of .50 cents per minute of playing time or fraction thereof, which, given the flat rate of 2.75 cents per work, applied to works that were longer than five and a half minutes in playing time. Overtime rates have been incorporated in every subsequent adjustment to the mechanical royalty rate. *See supra* Section II.C.2-5.

591. The 1981 decision of the CRT resulted in the continuation of the penny rate. The CRT raised the compulsory rate to 4 cents or .75 cents per minute of playing time or fraction thereof. The CRT’s determination also provided for scheduled rate

increases in subsequent years. *See supra* Section II.C.2; *see also* 37 C.F.R. § 255.3; 46 Fed. Reg. 62267-02.

592. Pursuant to industry-wide settlements in 1987 and 1997, the Copyright Owners and the record companies agreed to continuation of a penny rate featuring a fixed per track rate, plus an overtime rate, for physical products. As part of the 1997 settlement, the parties also agreed to a penny rate for permanent downloads. *See supra* Section II.C.4.

C. The Significance of the Penny Rate

1. The Penny Rate Is A Usage-Based Metric

593. The penny rates proposed by the Copyright Owners are usage-based metrics. 2/7/08 Tr. at 2173-74 (Landes) (explaining that the Copyright Owners' proposed penny rate is based on quantity and focuses exclusively on units). Because the penny rate is unit-based, the Copyright Owners are assured of the same compensation per use (*i.e.*, reproduction and distribution) regardless of how their works are used by Copyright Users. Landes WRT (CO Trial Ex. 406) at 22. The penny rate ensures that mechanical royalties will increase proportionately with the unit sales of music.

594. By contrast, a percentage of revenue rate does not necessarily correlate royalties and music use. As DiMA's economist, Ms. Guerin-Calvert, conceded, a mechanical royalty set on the basis of a percentage of revenue could well result in increased use of music without any corresponding increase in royalties. 2/25/08 Tr. at 4503 (Guerin-Calvert). Put another way, a percentage of revenue rate does not align the interests of the Copyright Owners with the users of their music. *See* Landes WRT (CO Trial Ex. 406) at 22.

595. Usage-based metrics, like the penny rate, are also advantageous because they are less complicated to apply and monitor than percentage rates. Under a penny rate, the mechanical royalties due to the Copyright Owners are the product of two factors: (1) the units distributed and (2) the applicable penny rate. *Pedecine WRT* (CO Trial Ex. 394) at 14-15; 2/7/08 Tr. at 2173 (Landes).

596. Calculating the mechanical royalty due under a percentage of revenue rate is more complex and may present measurement difficulties. For CDs or permanent downloads that are sold on a per-unit basis, calculating the mechanical royalty under a percentage system would involve the consideration of three factors: (1) the units distributed; (2) the percentage rate; and (3) and the sale price for each unit. *See Pedecine WRT* (CO Trial Ex. 394) at 15; 2/7/08 Tr. at 2173 (Landes).

597. Further, as discussed below, for music that is distributed as part of a bundle of goods or services, pursuant to wholesale discounts or through a barter transaction, determining the appropriate mechanical royalty is even more challenging, leading possibly to non-payment to the Copyright Owners for extensive use of their works. *Landes WRT* (CO Trial Ex. 406) at 25-26; *Pedecine WRT* (CO Trial Ex. 394) at 14-15. In fact, RIAA and DiMA witnesses asked to identify the appropriate revenue base in such circumstances struggled to come up with answers. *See, e.g.,* 5/6/08 Tr. at 4856-64 (*Guerin-Calvert*); 5/13/08 Tr. at 6136-37 (*Eisenberg*); 2/26/08 Tr. at 4628-31 (*Quirk*).

2. The Penny Rate Provides Important Protection for Copyright Owners

598. As the record evidence demonstrated, because the penny rate is a usage-based metric, it protects the intrinsic value of the Copyright Owners' musical compositions in the marketplace. 1/29/08 Tr. at 482 (*Faxon*) (the Copyright Owners' rate

proposal “meets the test . . . of the intrinsic value and the contributory value that is required in any negotiation for a price”). For that very reason, in almost every circumstance, the record companies themselves do not accept a percentage of revenue payment for their sound recordings without some type of minimum penny payment. 2/20/08 Tr. at 4019 (Wilcox) (minima in agreements between Sony BMG and digital music services “preserve[] the value of the music that we’re presenting in the marketplace to consumers”); 5/13/08 Tr. at 6112-13 (Eisenberg) (minima in same agreements are designed to provide “downside protection”); *see also, e.g.*, CO Trial Exs. 91, 112.

599. Although record companies are seeking to impose a percentage of revenue rate on the Copyright Owners, they sell CDs and other physical products for specific prices rather than for a percentage of retail revenue. *E.g.*, 2/20/08 Tr. at 4015 (Wilcox) (agreeing that “in the physical world, the way Sony chooses to sell its products at wholesale is not a percentage of retail,” and that “Sony has a price card with specific dollar amounts that it charges its distributors” for physical products).

600. Similarly, all of the agreements between record companies and digital music services in the record include payment terms to the record companies that are expressed in a usage-based metric, whether in pennies or dollars. *See* CO Trial Exs. 90-93, 112, 131, 132, 137 and 140; *see also* 2/25/08 Tr. at 4328-29 (Cue) ([REDACTED] [REDACTED]).

601. Warner, Sony BMG and Universal each receive [REDACTED] [REDACTED] from Apple each time one of their tracks is sold, and EMI receives [REDACTED]

[REDACTED]. CO Trial Ex. 91 at DiMA 3463; CO Trial Ex. 92 at DiMA 3781; CO Trial Ex. 90 at DiMA 3632; CO Trial Ex. 93 at DiMA 3717; *see also* Enders WDT (CO Trial Ex. 10) at 48. The major record companies' agreements with other digital music services for permanent downloads contain similar wholesale price terms. Enders WDT (CO Trial Ex. 10) at 53-54. For example, Universal charges Napster the [REDACTED] per track for permanent downloads. *Id.* at 53. EMI charges MusicNet [REDACTED] per track for permanent downloads, depending on factors including the retail release date of the album. CO Trial Ex. 112 at DIMA 10724; *see also* 2/20/08 Tr. at 4017 (Wilcox) (acknowledging that all of the "dozen or so download deals" that Sony entered into during his tenure at the company were "priced to the digital download service as the greater of a penny rate or a percentage of revenues").

602. The agreements between the major record companies and subscription services all have three tiers that govern payment to the majors—and, again, all provide for usage-based minima. Under these agreements the record companies are [REDACTED]

[REDACTED]
[REDACTED]
[REDACTED]

[REDACTED]. Enders WDT (CO Trial Ex. 10) at 52; *see also* 2/20/08 Tr. at 4018-19 (Wilcox); 5/13/08 Tr. at 6115-16 (Eisenberg). There is no agreement in evidence in which record companies are paid purely on a percentage of revenue basis.

603. For example, an agreement between MusicNet and EMI contains three price tiers for subscriptions: [REDACTED]

[REDACTED] CO Trial

Ex. 112 at DIMA 10724-25; 2/25/08 Tr. at 4416 (McGlade). MusicNet CEO Alan

McGlade acknowledged that although [REDACTED]

[REDACTED].” *Id.* at 4416-17. When asked if payments to EMI might be required under the third tier [REDACTED] Mr. McGlade conceded: [REDACTED] *Id.* at 4417.

604. Agreements between RealNetworks and all four of the major record companies contain a similar three-tier structure for subscriptions: [REDACTED]

[REDACTED] *See* CO Trial Ex. 131

(Subscription Services Agreement between Warner Music and RealNetworks) at DiMA 23083-84; CO Trial Ex. 132 (Subscription Agreement between UMG Recordings and RealNetworks) at RIAA 16862-63; CO Trial Ex. 137 (EMI Music Streaming Audio and Conditional Download Agreement with RealNetworks) at DiMA 22653; CO Trial Ex. 140 (Content Integration Agreement between Sony BMG and RealNetworks) at 22765-67; *see also* [REDACTED]

605. Mr. Wilcox explained why the record companies have, in their agreements with digital music services, declined to be paid solely on a percentage of revenue basis: “the priorities of a digital distribution partner might be different than maximizing . . . revenue.” 2/20/08 Tr. at 4020 (Wilcox). As Mr. Eisenberg testified, “Some of the [digital music] service providers that we license to are not in the business of selling music. They sell other goods and services or advertising related to other products. . . .

The minima in that case protects us for service providers who are in the business of something other than selling music.” 5/13/08 Tr. at 6112 (Eisenberg). Mr. Eisenberg added that music publishers and record companies “are not necessarily aligned with service providers who are in multiple businesses.” *Id.* at 6114.

606. The RIAA does not dispute that the record companies themselves are not compensated on a percentage of revenue basis. Rather, the RIAA argues that the interests of the Copyright Owners and record companies are sufficiently aligned to protect the Copyright Owners, which purportedly allows the statutory rate to be set as a percentage of revenue. *See* Teece WDT (RIAA Trial Ex. 64) at 71; A. Finkelstein WRT (RIAA Trial Ex. 84) at 15; 5/13/08 Tr. at 6114 (Eisenberg).

607. The RIAA’s argument is wrong as a matter of economics. As Professor Landes explained: “Economic theory predicts that, under some circumstances, the parties’ incentives may be better aligned by a royalty based on a percentage of *profit*, but as long as the record companies incur variable costs as part of their sales (such as the manufacturing and distribution costs necessary for CDs), profits and revenues diverge and the parties’ incentives will not be identical.” Landes WRT (CO Trial Ex. 406) at 22.

608. Professor Teece acknowledges this point, stating that the parties’ “interests are not perfectly aligned. Technically, songwriters/publishers are interested in maximizing their own profits . . . [and] they are interested in having the record companies maximize the volume of sales under a cents-per-tune regime and maximize total revenues under a percentage royalty regime. Record companies are interested in maximizing their profits. Profit maximization by the record companies does not imply revenue maximization” Teece WDT (RIAA Trial Ex. 64) at 71 n.79.

D. Percentage Rates Present the Risk of Revenue Manipulation

609. Another problem with a percentage of revenue royalty is “the possibility that reported revenue can be manipulated in order to reduce the royalties that copyright holders receive for their music.” Landes WRT (CO Trial Ex. 406) at 25-26. The revenue definitions proposed by the RIAA and DiMA are both susceptible to such manipulation.

610. First, under either the RIAA or the DiMA revenue definition, the Copyright Owners’ mechanical royalty revenues could be reduced if licensees use music as a “loss leader.” As Mr. Faxon testified, “it is entirely possible” that a licensee will “discount[] the value of the music in order to induce other behavior.” 1/29/08 Tr. at 437 (Faxon). For example, a licensee might sell music for a low retail price to generate advertising revenue or to encourage the sale of other products. *See* 5/13/08 Tr. at 6112 (Eisenberg) (some digital music services “are in the business of something other than selling music”).

611. Mr. Faxon’s concern is real, not theoretical. Apple has announced that its business strategy is to use the iTunes Store to drive the sale of profitable iPods. *See, e.g.*, CO Trial Ex. 88 at 12; 2/25/08 Tr. at 4305 (Cue). As a result, Apple’s incentive is to maximize the revenues of iPod sales, not music. Under a penny rate, unlike a percentage rate, the Copyright Owners are assured that the value of their compositions will be protected if companies such as Apple price music below the revenue-maximizing price.

612. Second, under both the RIAA and the DiMA rate proposals, the Copyright Owners’ mechanical royalties would be reduced if their works are sold in bundles with other products, at a combined price lower than the standalone prices of the bundled products. 5/12/08 Tr. at 5667 (A. Finkelstein).

613. Ms. Finkelstein explained how the RIAA proposal works: “We suggest that in the case where the bundle is of non-like products, that the price/the revenue would be split among the products based on the price of those products as stand-alones.” 5/12/08 Tr. at 5667 (A. Finkelstein). Therefore, the Copyright Owners would receive different—and lower—mechanical royalty revenues if their works were sold as part of bundles than if their works were sold with sound recordings in unbundled form.

614. DiMA’s witnesses gave strikingly inconsistent testimony on how DiMA’s rate proposal applies to bundles. Ms. Guerin-Calvert testified that if a consumer “bought an iPod for \$200 with 100 [permanent downloads],” the mechanical royalty payable “would be 4.8 cents per track,” or \$4.80. 5/6/08 Tr. at 4918 (Guerin-Calvert). When asked whether the mechanical royalty payment would be higher if a consumer “bought an iPod for \$100 and [separately] purchased the 100 songs,” Ms. Guerin-Calvert admitted: “Assuming those alternatives existed at those price points, that’s correct.” *Id.* at 4919. In fact, in the latter scenario, under the DiMA Proposal, the mechanical royalties due to the Copyright Owners would be 6% of \$99, or approximately \$6. *Cf. id.* In other words, assuming the facts above, the Copyright Owners’ mechanical royalties would be cut by approximately 20% if permanent downloads were sold in bundled form.

615. One week after Ms. Guerin-Calvert gave such testimony, Mr. Sheeran, another DiMA witness, gave conflicting testimony on direct examination about how DiMA’s rate proposal applies to bundles. 5/13/08 Tr. at 6180-81 (Sheeran). When asked how the DiMA proposal works “if permanent downloads were bundled with a device like a phone,” Mr. Sheeran answered: “In the case of permanent downloads, then the minimums would apply, and because there’s multiple downloads that are being bundled,

it would be the—I believe it’s [the] 3.3 cents per track rate.” *Id.* Thus, according to Mr. Sheeran, the Copyright Owners would receive even less than the 4.8 cents per track that Ms. Guerin-Calvert suggested. Given that the average retail price of a permanent download is 99 cents (producing a mechanical royalty of approximately 6 cents under DiMA’s proposal), at a bundled rate of 3.3 cents per track the Copyright Owners’ mechanical royalties would be cut by approximately 45% when permanent downloads were sold in bundled form, should DiMA’s proposal be adopted.

616. Regardless of whether Ms. Guerin-Calvert or Mr. Sheeran is in fact correct, there is no doubt that DiMA’s rate proposal would lead to a significant reduction in the Copyright Owners’ mechanical royalties in the event that permanent downloads are sold in bundles. Further, the fact that Ms. Guerin-Calvert and Mr. Sheeran gave conflicting testimony on the application of DiMA’s rate proposal to bundles illustrates that the proposal itself is unclear and ambiguous, and that adopting it could lead to confusion in the marketplace. *Compare* 5/6/08 Tr. at 4918 (Guerin-Calvert) *with* 5/13/08 Tr. at 6180-81 (Sheeran); *see also* 2/26/08 Tr. at 4628-31 (Quirk) (stating that he did not know DiMA’s rate proposal would apply to an iPod bundled with a subscription service and that, in fact, DiMA’s rate “does not break down . . . how you would react to that specific situation”). By contrast, a usage-based rate does not produce such confusion and does not vary depending on whether or not music is sold as part of a bundle, representing another way in which a penny rate preserves the value of the Copyright Owners’ compositions.

617. Third, under a revenue-based system, “users of music could barter their music services . . . without compensating copyright owners.” Landes WRT (CO Trial

Ex. 406) at 25-26. For example, Sony BMG recently entered into a deal in which it provided music to MySpace, an Internet business that operates a popular social networking website, and was compensated in part with an equity stake in MySpace. *See* 5/12/08 Tr. at 5716-19 (A. Finkelstein) (“there is an equity piece to the deal”). Ms. Finkelstein admitted that the value of the equity stake that Sony BMG received from MySpace was not “in any way included in the RIAA’s proposed definition of wholesale revenue.” *Id.* at 5718.

618. Fourth, the RIAA’s proposal would reduce the mechanical royalties payable for physical products by permitting the record companies to deduct “applicable sales discounts” from wholesale revenues as part of the calculation of the appropriate revenue base. RIAA Amended Proposal at 2 (Section II.A.i). The relevant testimony revealed that the RIAA’s rate proposal, just like DiMA’s, is unclear and ambiguous.

619. Mr. Eisenberg testified that “sometimes co-op payments . . . are made” by record companies to physical distributors, and sometimes wholesale discounts are given to these distributors. 5/13/08 Tr. at 6133 (Eisenberg) (“There’s monies that go back and forth.”). In exchange for co-op payments or sales discounts, record companies receive benefits from physical distributors such as premium product placement at retail outlets and inclusion of their products in advertising circulars. *Id.* at 6134; *see also* 5/12/08 Tr. at 5715 (A. Finkelstein) (“we would charge the retailer less for the product to encourage him to give a prominent placement in the store”).

620. For the purposes of calculating the mechanical royalty under the RIAA’s proposed definition of revenue, it makes a difference whether a co-op payment is made or a wholesale price discount is granted. Because a sales discount could be deducted from

the revenue base, the mechanical royalty payable to the Copyright Owners would be lower if the record company offered a discount instead of making a co-op payment. In other words, although the net economic result for the record company would be the same if it offered a retailer a discount in lieu of a co-op payment of the same amount, the effect on the Copyright Owners' mechanical royalties would be different. Mr. Eisenberg struggled to address this disparity during his testimony. *See* 5/13/08 Tr. at 6135-37 (Eisenberg). When asked what the revenue base would be under the RIAA's proposal in the situation where "Sony pays \$10 in co-op advertising to a retailer who pays Sony \$100 for the product," Mr. Eisenberg admitted that he did not know. *Id.* at 6136-37.

621. The fact that Mr. Eisenberg was unable to interpret how the RIAA's revenue definition dealt with co-op payments further illustrates the infirmity of the RIAA's proposal. *See id.* By contrast, co-op payments and sales discounts do not affect the Copyright Owners' remuneration for the sale of physical products under a penny rate regime—another advantage of a unit-based rate.

622. Fifth, the RIAA has proposed assuming that the applicable wholesale revenue is 70% of retail revenue when record companies directly distribute physical products and digital downloads, and 50% of retail revenue when record companies directly distribute ringtones. *See* RIAA Amended Proposal at 4 (Section II.C). The rationale is that "[b]ecause of the additional costs of retail distribution . . . it would not be fair to apply the same royalty percentage used for wholesale revenue to the higher revenues received at retail." A. Finkelstein WRT (RIAA Trial Ex. 84) at 17. But the RIAA has provided no empirical support for the 70% assumption, and did not quantify

the costs of retail distribution. *See* 5/12/08 Tr. at 5719-21 (A. Finkelstein). Nor is there any other support in the record for either the 70% or 50% assumptions.

E. The Digital Market Has Grown Dramatically Under a Penny Rate System

623. Both the RIAA and DiMA have claimed that their members need a percentage of revenue mechanical royalty to grow in the marketplace, to test new business models and to enter new markets. *See, e.g.*, Eisenberg WRT (RIAA Ex. 89) at 9; Munns WDT (RIAA Trial Ex. 76) at 13; Guerin-Calvert WDT (DiMA Trial Ex. 7) at 58-59. The evidence is to the contrary: the current mechanical rate structure has not hindered the ability of record companies and digital media companies to grow and innovate. Landes WDT (CO Trial Ex. 22) at 17-18. In particular, the permanent download market is booming, and a vast array of new products and services have been introduced by the record companies, all during a time when the mechanical royalty rate has been calculated on a penny basis. *See generally* Enders WDT (CO Trial Ex. 10). In fact, the growth in digital distribution in the United States has far outstripped all of the countries that calculate mechanical revenues on a percentage of revenue basis. *See* CO Trial Ex. 29 at 8.

624. As described above in Section VII.D.1, the permanent download model has experienced dramatic growth since its launch in 2003. By 2006, the market had reached \$878 million in sales, and it crossed the billion dollar threshold in 2007. Enders WDT (CO Trial Ex. 10) at 22, 23 n.46. Apple alone has already sold over 4 billion permanent downloads, and iTunes Store profits were “[REDACTED]” in 2007. 2/25/08 Tr. at 4295, 4268 (Cue).

625. DiMA's expert, Ms. Guerin-Calvert, has nonetheless contended that the penny rate itself, and its current level, have prevented entry into and expansion of the digital market. *See* 5/6/08 Tr. at 4831 (Guerin-Calvert). The argument is undermined not only by the indisputable growth of the market but also by Ms. Guerin-Calvert's own analysis. As she reports, eight companies have entered the permanent download market in recent years. *Id.* at 4832; Guerin-Calvert WRT (DiMA Trial Ex. 10) at 10. And each of these companies entered the market notwithstanding the fact that the mechanical rate for permanent downloads is calculated on a penny basis. 5/6/08 Tr. at 4833 (Guerin-Calvert). In fact, both Wal-Mart and Amazon have entered the business and sold downloads at a retail price below the 99-cent iTunes price. *See id.* at 4832; Guerin-Calvert WRT (DiMA Trial Ex. 10) at 10 (average price of Wal-Mart's permanent downloads is 94 cents, and average price of Amazon's permanent downloads is 89 cents). Although Ms. Guerin-Calvert speculated that these companies might have premised their entry into the market on an expected discontinuation of the penny rate, there is no evidence to convert that speculation into fact. 5/6/08 Tr. at 4834-37 (Guerin-Calvert) (admission by Ms. Guerin-Calvert that she had no such discussions with any entrants into the market); *see also* 2/25/08 Tr. at 4296 (Cue) (conceding that [REDACTED]).

626. RIAA witnesses also suggested that a percentage of revenue royalty is required to foster growth and innovation in the digital distribution of music. But the suggestion is advanced in the face of robust evidence of innovation and new product development that has occurred in recent years. Mr. Wilcox testified that "record companies and their technology partners have created a wide array of new products and

services and developed innovative new marketing strategies. We have created new business models and arrangements to form the basis of the emerging digital marketplace.” Wilcox WDT (RIAA Trial Ex. 70) at 2. According to Mr. Wilcox, “[t]he range of product and service offerings in the marketplace is already incredible, and is only going to become more so.” *Id.* at 9. All of this innovation occurred under the penny rate. 2/20/08 Tr. at 4088-89 (Hughes) (all of the technological innovations made by the record companies in the past decade occurred while the mechanical rate was calculated on a penny basis).

627. Today, in the digital world, there may be as many as 200 different products associated with an album. Kushner WDT (RIAA Trial Ex. 62) at 20; *see also* Munns WDT (RIAA Trial Ex. 76) at RIAA Ex. B-201-DR (list of 93 products for the Coldplay X&Y album); 2/20/08 Tr. at 4079-80 (Hughes) (stating that in today’s market, “in many cases there are many dozens of products that result from [a] single project”). In addition to producing a vast array of products from a single album, record companies have developed a variety of new business models and entered into new kinds of partnerships for selling music to consumers. Two examples are Nokia’s “Comes With Music” service and Sony BMG’s digital album cards.

628. Both Universal and Sony BMG have entered into agreements with Nokia for a program called “Comes With Music.” Eisenberg WRT (RIAA Trial Ex. 89) at 13; 5/13/08 Tr. at 6052 (Eisenberg). Sony BMG entered into the Nokia agreement just a few months ago, in April of 2008. *See* CO Trial Ex. 352. The “Comes With Music” program enables the purchaser of a Nokia cellular phone to receive a year’s supply of unlimited music, which can be permanently downloaded to the phone and to a personal computer.

Eisenberg WRT (RIAA Trial Ex. 89) at 13; 5/14/08 Tr. at 6052-6053 (Eisenberg). Mr. Eisenberg professed to be “excited” about “Comes With Music,” characterizing it as “an opportunity to really grow the digital -- not only the digital market, but . . . the recorded music market in general.” 5/13/08 Tr. at 6053 (Eisenberg); Eisenberg WRT (RIAA Trial Ex. 89) at 13.

629. Although Mr. Eisenberg testified that a percentage of revenue royalty is required to facilitate the negotiation of deals such as the one Sony BMG just struck with Nokia, *id.* at 6093-94, in fact the 9.1-cent mechanical rate did not impede the successful conclusion of the agreement. Nothing in the Nokia agreement conditions the agreement upon a percentage of revenue rate or, for that matter, a reduction in the current penny rate. *Id.* at 6096-6104. As with iTunes, Sony BMG has the responsibility for paying mechanical royalties for sales of permanent downloads, even if they continue to be calculated on a penny basis. *Id.* at 6099-6100 (Sony BMG bears the risk of the market). And although Mr. Eisenberg testified that Nokia requested the right to terminate other aspects of the agreement in the event that mechanical royalties were increased, nothing on the face of the Nokia agreement links termination to mechanical royalties. *Id.* at 6097, 6103-05.

630. Sony BMG also launched a new physical product, the digital album card, in January 2008 under the name “Music Pass.” Eisenberg WRT (RIAA Trial Ex. 89) at 19. Digital album cards are wallet-sized cards containing a scratch-off code that allows the consumer to download a digital album (containing additional tracks and bonus content not available on the CD release) or track-bundle from a Sony BMG website. *Id.*; 5/13/08 Tr. at 6066-67 (Eisenberg). According to Mr. Eisenberg, “[t]he digital album

cards are a way for Sony BMG to secure additional points of sale and to get its music into more ‘brick and mortar’ physical retail outlets.” Eisenberg WRT (RIAA Trial Ex. 89) at 20. The penny rate did not preclude Sony BMG from launching the product. 5/13/08 Tr. at 6132 (Eisenberg). Indeed, the digital album card has also been launched in Canada, where the recording industry just agreed to pay mechanical royalties on a penny basis at higher rates. *Id.* at 6132-33.

631. The RIAA also claimed that a percentage of revenue rate would allow the introduction of new physical products that were either priced below the current price of CDs or contained more tracks than are possible under the current per track mechanical royalty regime. *See, e.g.*, Slottje WRT (RIAA Trial Ex. 81) at 18; Emmer WRT (RIAA Trial Ex. 90) at 10-12. These arguments are undercut by economic theory and market practices.

632. First, as Professor Landes has explained, “it is generally in the interest of the publishers and songwriters to encourage new models of distribution for their copyrighted works where these new models are expected to increase the sales of those works.” Landes WRT (CO Trial Ex. 406) at 23. Therefore, in the event that the record companies can demonstrate to the Copyright Owners that they can benefit from the release of an album that contains, for example, 20 or 30 tracks, a lower rate could be achieved through voluntary negotiation. *Id.* at 23-24. Consistent with this economic principle, Copyright Owners have historically granted reductions in mechanical royalties for low-priced and compilation CDs. *See, e.g.*, 5/14/08 Tr. at 6425-26 (Faxon); 2/12/08 Tr. at 2683 (Firth); 2/5/08 Tr. at 1666-67 (Peer).

633. Second, to the extent that the record companies seek a method for reducing mechanical royalty costs on CDs with numerous tracks, they already have such a tool at their disposal: the controlled composition clause. As set forth in Section IV.C.2.b, such clauses typically contain a 10-song cap that limits mechanical royalty payments. *See also* 5/12/08 Tr. at 5721-22 (A. Finkelstein). Further, these caps permit record companies to recoup any mechanical royalties paid out in excess of the cap from artist royalties. *See id.* at 5722-24.

F. Evidence from International Markets Undermines Percentage Rates

634. The growth in the U.S. digital market has far outpaced digital growth in virtually every country in which mechanical royalties are calculated on a percentage of revenue basis. *See* CO Trial Ex. 29 at 8. This market fact is utterly inconsistent with the contentions of the RIAA and DiMA that a percentage rate is required to promote growth in the digital market.

635. The digital market constitutes a larger percentage of total music sales in the U.S. than in other parts of the world. Data from IFPI—the international trade association of the recorded music companies—for 2006 show that the U.S. was “the largest digital music market in the world, accounting for 52% of global digital sales, followed by Asia (26%) and Europe (18%).” *Id.* at 11. By comparison, the U.S. accounts for only 33% of the total global recorded music market. *Id.* at 8.

636. Further, in the U.S., the digital market accounted for 17% of total recorded music sales in 2006 and 30% in 2007. *Id.* at 21; 2/4/08 Tr. at 1246-47 (Enders). The level of digital penetration is thus approximately three times higher in the U.S. market than in the five largest European markets. In 2006, digital sales account for 6% of total sales in France, Italy and the U.K., and 5% in Germany and Spain. CO Trial Ex. 29 at

21, 27, 28, 32, 38 and 42. Each of these countries feature percentage of revenue mechanical royalty regimes. *See* Fabinyi WRT (CO Trial Ex. 380) at Exs. F-1, F-2. In Japan, Asia's largest recorded music market, in which mechanical royalties are paid on a percentage of revenue basis, digital sales account for 11% of total sales, as opposed to 17 percent in the United States. *Id.* at 8, 47.

637. Finally, the RIAA's claim that record companies require a percentage of revenue royalty is undermined by the November 2007 agreement setting new mechanical royalty rates in Canada. Historically, mechanical royalties in Canada, like the United States, were paid on a penny basis. The recently-concluded agreement continued the Canadian penny rate for physical products. Fabinyi WRT (CO Trial Ex. 380) at 11. The Canadian agreement "increased the usage-based rate from 7.7 CAD cents to 8.1 CAD cents for the period 2007-09 and 8.3 CAD cents in 2010-12." *Id.*; *see also* 2/13/08 Tr. at 3206 (C. Finkelstein) (acknowledging that there was a voluntary agreement by the recorded music industry, including EMI, in November of 2007 to continue the penny rate in Canada and to increase it above the current rate); 5/13/08 Tr. at 6132-33 (Eisenberg) (Sony BMG is a signatory to an agreement for a new Canadian mechanical royalty rate that is calculated on a penny basis).

G. The Copyright Owners' Rate Proposal Will Not Be Difficult to Administer

638. The RIAA asserts that the Copyright Owners' proposed rates are difficult to administer. This argument cannot be made with respect to physical products and permanent downloads, which are already subject to a penny rate, and will require no change for administration. Rather, the RIAA appears principally to be complaining about rates for limited downloads and interactive streaming, both of which are subject to the

Partial Settlement. *See* A. Finkelstein WRT (RIAA Trial Ex. 84) at 4; *see also* 5/12/08 Tr. at 5639-42 (A. Finkelstein). To the extent that the RIAA is raising an issue with respect to the ringtone rate, the Copyright Owners' proposal largely follows the structure of NDMA's and other marketplace agreements for ringtones and should be no more difficult to administer.

639. The evidence shows that the penny rate is in fact easier to administer than a percentage of revenue rate for physical products and permanent downloads. A penny rate requires consideration of only two factors (unit sales and the applicable rate), while determination of a percentage rate also involves assessment of price. 2/7/08 Tr. at 2173 (Landes). Price varies widely across physical product, further complicating the necessary royalty calculation. Slottje WRT (RIAA Trial Ex. 81) at 18 ("prices for recorded music vary widely across different formats, distribution methods, geography, etc."); *see also* 5/12/08 Tr. at 5708 (A. Finkelstein) (noting different price points for physical product).

640. The RIAA's other criticisms of the penny rate will not be allayed by a switch to a percentage rate.

641. First, the RIAA complains about the length of time it takes to resolve split royalty rights when multiple songwriters control portions of a song. *See, e.g.*, Finkelstein WDT (RIAA Trial Ex. 61) at 6-11. The process of resolving split royalties does not delay the release of albums by record companies; it only delays payment to songwriters and music publishers. 2/14/08 Tr. at 3389-90 (A. Finkelstein) ("We don't usually delay the release because we don't have the splits, because in most cases, we have a controlled license which effectively grants the license for the entire work."); 5/19/08 Tr. at 7082-83 (Pedecine) (product is sometimes in the marketplace "for the better part [of] a year"

before it is licensed). Moreover, computing royalties on a percentage of revenue basis will do nothing to solve split issues. 2/14/08 Tr. at 3391 (A. Finkelstein).

642. The RIAA has also lodged complaints about delays in the licensing process, generally. But the evidence makes clear that mechanical licensing at the statutory rate through HFA is a quick, efficient process. Ms. Finkelstein testified that requests for mechanical licenses at the statutory rate through HFA are “generally do[ne] . . . electronically and in bulk, and if the song is in HFA’s database, the license is issued electronically, or even automatically.” A. Finkelstein WRT (RIAA Trial Ex. 84) at 28; *see also* 2/14/08 Tr. at 3374-75 (A. Finkelstein) (testifying that the online process of licensing at the statutory rate is quick); *id.* at 3372-73 (HFA’s voluntary licensing procedures are less burdensome than the compulsory process).

643. Third, even though the RIAA has claimed that its proposal will reduce disputes between the parties as to what the applicable rate should be for a new product or service, the adoption of a percentage rate will not avoid disputes over whether a particular new product or service is licensable under Section 115, as the Court has noted. *See* 5/12/08 Tr. at 5710-11 (A. Finkelstein); 2/14/08 Tr. at 3352-61.

H. Abandoning the Penny Rate Will Cause Disruption in the Industry

644. Over nearly 100 years, the Copyright Owners and copyright users have developed contractual relationships, licensing schemes and royalty collecting systems in the U.S. that are tied to the penny rate structure. A change to a percentage of revenue system would cause significant disruption to these relationships and systems. *See* Landes WRT (CO Trial Ex. 406) at 24 (“imposing a percentage of revenue royalty” would have a disruptive impact on “the structure of the industry and prevailing industry practice”).

645. First, abandoning the penny rate and moving to a percentage model for physical products would disrupt existing contractual relationships between music publishers and songwriters. Mr. Faxon testified that such a change would be “hugely disruptive to [EMI MP’s] contractual relationships.” 1/29/08 Tr. at 479 (Faxon). EMI MP currently has approximately 700 contracts with songwriters, and based on a review of 561 of those contracts signed since 2000, 492—or approximately 88% of them—contain clauses that depend on the existence of a penny rate. 5/14/08 Tr. at 6428 (Faxon). “[T]he songwriter’s obligation to provide additional material and maintain the contract in effect is defined based on the penny rate.” Faxon WRT (CO Trial Ex. 375) at 16, Exhibit K; *see also* 1/29/08 Tr. at 479 (Faxon). That is because the obligations of EMI MP songwriters are typically discharged by the delivery of songs that have a certain penny value. *See* Faxon WRT (CO Trial Ex. 375) at 16, Exhibit K. “If there is no penny rate (or a significantly reduced penny rate) the songwriter will not be able to meet this penny rate obligation, which constitutes a default under the contract that can result in termination and return of advances.” *Id.* at 16.

646. The abolition of the penny rate would require EMI MP to renegotiate hundreds of songwriter agreements. 5/14/08 Tr. at 6437 (Faxon). This problem is not unique to EMI MP. Throughout the music industry, there are “[REDACTED] [REDACTED] between publishers and songwriters [REDACTED]” *Id.*

647. Even the RIAA agreed that “the transition from a cents rate royalty to a percentage royalty will take some time” and that it will be “a significant project to recalculate royalty allocations for our back catalog and code them into our accounting system.” A. Finkelstein WDT (RIAA Trial Ex. 61) at 16; *see also* A. Finkelstein WRT

(RIAA Trial Ex. 84) at 21 (“If this Court adopts a percentage rate, it will take a certain time to implement the new rate structure in the computer systems Sony BMG uses for royalty distribution.”); 2/14/08 Tr. at 3408-09 (Finkelstein).

648. Abandonment of the penny rate will also complicate the efforts of Copyright Owners to audit and monitor the copyright users’ compliance with mechanical royalty obligations. Auditing a percentage of revenue rate requires audit of the revenue base, inherently a more difficult exercise than simply auditing the volume of units sold. Pedecine WRT (CO Trial Ex. 394) at 14-15 (audit of percentage rate “requires an understanding of the licensee’s various revenue sources and revenue recognition”). The already complicated and expensive audit process would necessarily be more difficult under a percentage of revenue regime. *Id.*

I. The Copyright Owners’ Ringtone Rate Proposal Follows Market Agreements

649. Both the Copyright Owners and the RIAA have proposed that ringtone rates be set at least in part on a percentage of revenue. The principal difference between the parties’ rate proposals, other than the level of the percentage rate and the appropriate revenue base, is that the Copyright Owners’ proposal contains a penny minimum that is essential to preserving the value of the Copyright Owners’ musical compositions.

650. The evidence shows that a minimum royalty for ringtones is consistent with the historical and existing marketplace for ringtones. Music publishers have typically licensed ringtones on a greater of a minimum penny rate or a percentage of revenue basis. Landes WDT (CO Trial Ex. 22) at 40 (reviewing nearly 200 ringtone agreements from six different music publishers spanning the years 2004, 2005 and 2006). Ringtone agreements with record companies, including NDMAAs, are consistent with that

structure. Record companies have agreed to pay a fee equal to the greater of \$0.10, 10% of the retail price or 20% of the wholesale price for each mastertone sold. *See supra* Section XII.C.1.b; *see also* 5/12/08 Tr. at 5711-12 (A. Finkelstein) (Sony BMG pays for ringtones on a “multipart” basis).

651. The Copyright Owners’ proposed penny minimum for ringtones, as for other digital products, is essential to guarding against the vagaries of the revenue base that are inherent in any percentage of revenue system. 1/29/08 Tr. at 480 (Faxon) (Copyright Owners’ rate proposal maintains “the intrinsic value” of musical compositions); Landes WRT (CO Trial Ex. 406) at 25-26 (revenue base can be manipulated under percentage, but not unit-based, royalty system). Indeed, the 15-cent minimum in the Copyright Owners’ proposal is lower than the 18-cent rate contained in the RIAA’s alternative penny rate proposal, foreclosing any argument that the Copyright Owners’ proposal is burdensome or disruptive.

652. The Copyright Owners’ ringtone proposal is also consistent with the protections record companies insist on for themselves in agreements for the sale of ringtones. “The agreements between the record companies and third-party ringtone providers typically provide the record companies with the greater of 50 percent of the retail price or \$1.00 for every ringtone sold; one company commonly licenses its recordings for a flat rate, ranging in its agreements from \$1.00 to \$1.35.” Landes WDT (CO Trial Ex. 22) at 46; *see also* CO Trial Ex. 47. The RIAA has offered no evidence that would lead to the conclusion that the Copyright Owners do not deserve the same downward protection afforded by a minimum fee.

XV. The RIAA's Arguments In Favor Of Their Rate Proposals Lack Merit

A. The RIAA's Proposal Would Cut the Mechanical Royalty Rate Significantly

653. The RIAA's rate proposals, discussed in detail above, *see supra* XIV.A, would effect a significant reduction in the current mechanical royalty rate. The RIAA's primary rate proposal for physical products and permanent downloads is 9% of wholesale revenue, and its proposal for ringtones is 15% of wholesale revenue. RIAA Amended Proposal at 1. In the alternative, the RIAA has proposed a tiered penny rate for physical products and permanent downloads that purportedly was calculated by converting its wholesale percentage rate proposal at various per-track wholesale price points. *Id.* at 5-6.

654. Although the RIAA has provided a range of penny rates, as a practical matter its proposed rate of 6.3 cents per track for physical products and permanent downloads (when the wholesale price of the track is 60 cents or more but below 80 cents) is most pertinent. According to the RIAA, the average CD sells at a wholesale price of \$8.49, Teece WDT (RIAA Trial Ex. 64) at 81, and contains 13 tracks, RIAA Amended Proposal at 5 n. 1. Thus, the average physical track sells for a wholesale price of 65 cents and, under the RIAA's rate proposal, would receive 6.3 cents as a mechanical royalty—a reduction of nearly one-third of the current rate of 9.1 cents. Similarly, a single permanent download typically sells at a wholesale price of 70 cents, Landes WDT (CO Trial Ex. 22) at 36; 2/7/08 Tr. at 2178 (Landes), and would also receive a mechanical royalty of just 6.3 cents under the RIAA's primary proposal. The RIAA's alternative rate proposal for ringtones is 18 cents, a rate likewise calculated by converting the RIAA's percentage proposal into a penny rate. RIAA Amended Proposal at 6. This 15% share of wholesale revenue is a reduction of approximately one-quarter of what Copyright Owners

have received in the ringtone and mastertone market in freely-negotiated market agreements. *See supra* XII.C.1.b.

655. As explained in further detail below, the RIAA's arguments in support of these significant rate reductions are meritless. The RIAA's proposed benchmarks are each deficient. Moreover, the RIAA's principal arguments concerning the roles and risks of record companies, music publishers and songwriters all find little (if any) support in the record.

B. The RIAA's Proposed Benchmarks for Setting Rates Lack Merit

1. Overview

656. Each of the proposed benchmarks put forth by the RIAA's experts at both the direct and rebuttal phases of this proceeding lack merit.

657. During the direct portion of this proceeding, the RIAA's then-expert economist, Professor Teece, put forward its primary benchmark: the decision of the CRT in 1981. Teece WDT (RIAA Trial Ex. 64) at 76-81. Based on that decision, Professor Teece claimed that an appropriate statutory rate going forward would be 7.8% of wholesale revenue for physical products and permanent downloads. *Id.* at 8-9. He testified further that this rate should be "a ceiling" and that this Court "should adjust down from there." *Id.* at 81.

658. Professor Teece's testimony during the direct phase of the trial made clear that both his benchmark and derived rate were unsupportable. Professor Teece urged this Court to take heed of what he described as dramatic changes in the recorded music industry, while at the same time arguing that a decision from nearly 30 years ago could pave the way forward. *See infra* XV.B.2.a. Moreover, Professor Teece's methodology for deriving the 7.8% rate was empirically baseless. *See infra* XV.B.2.b. His calculation

depended upon his assumption that all albums were sold at retail list price when the evidence before the CRT submitted by the RIAA itself was directly to the contrary.

659. In the rebuttal phase of the proceeding, the RIAA proposed entirely new rates based on new benchmarks and supported by new economists. *See supra* XIV.A. The RIAA's revised primary rate proposal is 9 percent of wholesale revenue for physical products and permanent downloads and 15 percent of wholesale revenue for ringtones (a product that Professor Teece did not address at all in his testimony). As a "not preferred" alternative, the RIAA proposes a penny rate that is intended to yield the same license fees as its percentage of revenue proposal. Thus, for physical products and downloads, which comprise the overwhelming fraction of the recorded music market, the RIAA is now proposing rates that are entirely inconsistent with Professor Teece's assertion that 7.8% of wholesale constituted "a ceiling" on a reasonable royalty rate under Section 115. *Compare supra* XIV.A with Teece WDT (RIAA Trial Ex. 64) at 81.

660. On rebuttal, relying on the work of its substitute economist, Professor Wildman, the RIAA attempted to support its new rates on the basis of two new benchmarks: (1) the effective mechanical royalty rate paid by copyright users; and (2) the royalty rates paid for first uses of musical compositions, which are not subject to compulsory licensing. Wildman WRT (RIAA Trial Ex. 87) at 35-44. These new benchmarks are no more supported by the weight of the evidence than the one proffered by Professor Teece. Both the effective and first use rates are inherently unsuitable as benchmarks because they are not independent market rates. *See, e.g.,* 5/12/08 Tr. at 5893-94 (Wildman). Rather, the evidence adduced at the rebuttal trial demonstrates that the effective and first use rates calculated by Professor Wildman are derivative of the

statutory rate. As a result, neither of these rates provide any guidance as to a reasonable statutory rate. And even if such rates could provide guidance, the rates proffered by Professor Wildman are of little probative value because they are calculated on the basis of a limited and flawed empirical analysis. *See id.* at 5844-45, 5908-33.

661. At the direct trial, the RIAA also attempted to buttress Professor Teece's testimony with cherry-picked evidence of rates for physical and digital products in the United Kingdom and Japan. The RIAA imported two witnesses from the U.K. online proceeding, Mr. Taylor and Mr. Boulton, to support the RIAA's claim that the dramatic cut in the mechanical rate it proposed was consistent with lower rates in those two countries. Mr. Boulton testified that the U.K. rates were appropriate "cross-checks" on the statutory rate in the U.S. 2/13/08 Tr. at 2939 (Boulton). Mr. Taylor likewise argued that "the mechanical royalty rate schemes in the U.K. and Japan provide useful guidance" for setting the U.S. rate and that both rates suggested that the current statutory rate was too high. Taylor WDT (RIAA Trial Ex. 53) at 1.

662. The RIAA's reliance on the U.K. and Japanese rates is misplaced. Its own rebuttal economist, Professor Wildman, conceded that he could not support those rates as benchmarks because he had not applied his own criteria to test their appropriateness. 5/12/08 Tr. at 5987-88 (Wildman). There are also fundamental differences in mechanical licensing in the U.S., the U.K. and Japan. The prevalence of controlled composition clauses in the U.S. has no counterpart in the U.K., where such clauses are not enforced. Fabinyi WRT (CO Trial Ex. 380) at 4-6. Thus, the mechanical rate in the U.K. is the effective rate, whereas in the U.S. parties have the capacity to negotiate below the statutory rate. *See* 5/15/08 Tr. at 6789-91 (Fabinyi). In addition, as Mr. Fabinyi

demonstrated, a fair and balanced analysis of international rates demonstrates that the current U.S. mechanical rate is not out of line with international precedent and, if anything, is at the low end of mechanical rates when compared to other countries. *See* Fabinyi WRT (CO Trial Ex. 380), Exs. F-1, F-2.

663. In short, the RIAA has failed to identify a single market benchmark that can guide this Court in setting a statutory rate.

2. The 1981 CRT Decision Is Not A Viable Benchmark

664. In the direct phase, the RIAA asserted that the 1981 CRT decision should be employed as a benchmark to justify its proposed mechanical rate of 7.8% of wholesale revenue. *See* Teece WDT (RIAA Trial Ex. 64) at 6-9. The RIAA abandoned this benchmark on rebuttal. For good reason: Professor Teece is wrong as a matter of economic theory and the facts.

(a) The Market Has Changed Since 1981

665. The recorded music market has fundamentally changed since the CRT's decision in 1981. Teece WDT (RIAA Trial Ex. 64) at 109. As Professor Teece himself observed, "the recording industry is in the midst of a significant and sustained disruption of its 'structure' and 'industry practices.'" *Id.* at 109. He testified that "until 2000, this industry was going through what I called 'evolutionary change,' and there were ups and downs associated with new formats and business cycle issues. Now, I think we're in transformational change." 2/19/08 Tr. at 3640 (Teece). The industry today is "a completely different ball of wax," *id.* and is undergoing a "structural shift," *id.* at 3641.

666. There cannot be any dispute that the recorded music industry today is a fundamentally different one than the CRT passed on in 1981. Since 1981, the industry has seen two format shifts, a period of contraction, and a rise in new digital distribution

methods that have ushered in improved margins and profitability and a bright future. Given these transformational changes, there is little justification for relying in this proceeding on a nearly 30-year-old decision premised on industry conditions that have not obtained for some time. *See* 2/19/08 Tr. at 3642-45 (Roberts, J.).

(b) Professor Teece's Assertions About Average List Price are Incorrect

667. Professor Teece's claim that a rate of 7.8% of wholesale can be derived from the 1981 CRT decision is contradicted by the record of that proceeding.

(i) Professor Teece's Rate Calculation

668. The first step in Professor Teece's methodology is to convert the 4 cent penny rate held to be reasonable by the CRT into a percentage of revenue. To do so, Professor Teece relied on the CRT's finding that an average phonorecord at the time had 10 tracks. He therefore concluded that mechanical royalties constituted 40 cents, or 5 percent of the retail list price of \$7.98 per album. Teece WDT (RIAA Trial Ex. 64) at 77 n.94; *see also* 2/19/08 Tr. at 3678-79 (Teece).

669. Professor Teece then multiplied this "implied" 5 percent rate by \$13.24, the actual average retail price (*i.e.*, not the "list price") for a CD in 2005. Teece WDT (RIAA Trial Ex. 64) at 81; 2/19/08 Tr. at 3679-90 (Teece). This produces a royalty per CD of \$0.662. Teece WDT (RIAA Trial Ex. 64) at 81; 2/19/08 Tr. at 3679-80 (Teece). To derive a wholesale percentage rate, Professor Teece then divided the \$0.662 royalty per CD by the average wholesale CD price in 2005, \$8.49, yielding a wholesale percentage rate of 7.8%. Teece WDT (RIAA Trial Ex. 64) at 81; 2/19/08 Tr. at 3679 (Teece). Based on this analysis, Professor Teece opined that "the Copyright Royalty Judges should consider 7.8 percent of wholesale revenue a ceiling and should adjust

down from there in accordance with the Section 801(b) objectives.” Teece WDT (RIAA Trial Ex. 64) at 81.

(ii) Errors in Professor Teece’s Calculation

670. The critical flaw in this calculation was Professor Teece’s assumption that “[t]he 1981 CRT treated retail ‘list price’ (\$7.98 in 1981) as the *functional equivalent* of actual retail price in its assessment of the relationship between price and the mechanical royalty rate.” Teece WDT (RIAA Trial Ex. 64) at 80 (emphasis added); *see also* 2/19/08 Tr. at 3681-82 (Teece). He claimed that this judgment was “reasonable . . . because (as I understand it) most LPs were sold by record stores at prices at or near the list price.” Teece WDT (RIAA Trial Ex. 64) at 80; *see also* 2/19/08 Tr. at 3681-83 (Teece). The record before the CRT was to the contrary.

671. First, the 1981 CRT decision never concluded that the mechanical royalty rate should be viewed as a percentage of retail price, list or otherwise. In fact, the CRT considered and rejected the suggestion that the mechanical rate be a percentage of revenue, electing instead to maintain the historical penny rate. *See* Adjustment of Royalty Payable Under Compulsory License for Making and Distributing Phonorecords (C.R.T. 1981), 46 Fed. Reg. 10466 at 10477 (Feb. 3, 1981). Professor Teece conceded as much at trial. 2/19/08 Tr. at 3773-74 (Teece).

672. The evidence before the CRT at the time of its 1981 decision directly contradicts Professor Teece’s assumption that the retail list price and actual retail price were the same in the years leading up to the 1981 CRT decision, Teece WDT (RIAA Trial Ex. 64) at 80. It demonstrates that the actual average retail price was \$5.79—or 27 percent *less than* \$7.98, the figure Professor Teece used. *See* 46 Fed. Reg. at 10477. In its only reference to actual retail prices, the CRT cited a study by the RIAA showing that

“during the period 1974-1979, the average actual selling price of LP’s increased from \$4.05 to \$5.79.” *Id.*¹⁰ Confronted with this at trial, Professor Teece conceded that he had not considered this finding by the CRT. 2/19/08 Tr. at 3780 (Teece). He also admitted that he had no knowledge of discounting practices in the industry at the time of the 1981 decision. *Id.* at 3787-88. And he acknowledged that he had not seen the relevant pricing data—which bore directly on his calculations and was submitted in 1980 by the same party that retained him for this proceeding, the RIAA—when he submitted his written testimony. *See id.*

673. Thus, Professor Teece’s benchmark based on the 1981 CRT decision is entitled to no weight. Had Professor Teece used the correct retail price, he would have premised his calculation on an implied retail percentage of 6.9 rather than 5 percent. 2/19/08 Tr. at 3788 (Teece). That would have led to a wholesale percentage that was 38 percent *higher* ($6.9/5$) than the one that he sponsored at trial. *See id.*

674. There is another reason why Professor Teece’s benchmark is entitled to no weight: he never considered the revenue base against which the percentage rate would be applied. Although Professor Teece opined that “[i]t makes no sense to set the rate independently of the base,” Teece WDT (RIAA Trial Ex. 64) at 74, in fact he never reached a judgment as an economist as to what would be a reasonable revenue base. 2/19/08 Tr. at 3698-3701 (Teece). As a result, to quote Professor Teece, his opinion as to an appropriate percentage of revenue “makes no sense.” *Id.* at 3700.

¹⁰ The album pricing data provided to the CRT by the RIAA showed that, during the period from 1974 to 1979, the average actual retail price was consistently about 18 percent lower than the retail list price. *See* 46 Fed. Reg. at 10485; 2/19/08 Tr. at 3781-82 (Teece). During that time period, retail list price increased from \$4.91 to

3. Professor Wildman's Benchmarks Are Not Appropriate

675. Professor Wildman, the RIAA's principal economist on rebuttal, proposed two entirely new benchmarks for the mechanical royalty rate for physical products, permanent downloads, and ringtones: (1) the effective mechanical royalty rate and (2) the rates for first use licenses of musical compositions. Wildman WRT (RIAA Trial Ex. 87) at 35-44.

676. As a simple matter of economic theory, neither of these proposed benchmarks provides an appropriate basis for setting the Section 115 statutory rate because they are both, in fact, derivative of that rate. Even if they were appropriate benchmarks, Professor Wildman's empirical analysis of these rates is defective and provides insufficient evidence with which to set a statutory rate. Like the RIAA's other benchmarks, Professor Wildman's benchmarks are meritless.

(a) The Effective Mechanical Royalty Rate is Not an Appropriate Benchmark

677. Through Professor Wildman, the RIAA posits that the effective mechanical royalty rate—the rate at which mechanical licenses are actually paid in the market—should be used as a benchmark for determining the statutory mechanical rate. *See* Wildman WRT (RIAA Trial Ex. 87) at 37-42. Professor Wildman argues that the effective rate is preferable to alternative benchmarks for two principal reasons. First, the effective rate is based on licensing activity for the same rights at issue in this proceeding—mechanical rights for musical compositions. *Id.* at 30. Second, the effective rate is based on rates contained in licenses for “the same products that are the

\$7.09, while the average actual price increased from \$4.05 to \$5.79. 46 Fed. Reg. at 10485; *see also* 2/19/08 Tr. at 3782 (Teece).

central issue in this proceeding (rights to create copies of sound recordings to be purchased by consumers for their listening pleasure).” *Id.*

678. Mechanical licenses that are not issued at the statutory rate are licensed at rates below the statutory rate. *Id.* at 33. As Professor Wildman notes, these reduced rates are “[f]requently” the result of rates dictated in controlled composition clauses. *Id.* That voluntary licenses are issued below the statutory rate is consistent with the observation by Professor Landes and Professor Murphy that the statutory rate creates a “ceiling” on mechanical licensing rates. *See* Landes WRT (CO Trial Ex. 406) at 39; 5/15/08 Tr. at 6903-06 (K. Murphy); *see also supra* XIII.A.

679. Professor Wildman draws a conclusion from this licensing below the statutory rate, however, that neither Professor Landes nor the weight of the evidence can support. According to Professor Wildman, this below statutory licensing activity demonstrates that “the market rate for mechanical rights is below the current statutory rate.” Wildman WRT (RIAA Trial Ex. 87) at 34. His conclusion is wrong as a matter of economics and wrong as a matter of fact.

680. As Professor Murphy testified, basic economic theory dictates that in the presence of a statutory rate, musical compositions will sell at or below the statutory rate. K. Murphy WRT (CO Trial Ex. 400) at 17; 5/15/08 Tr. at 6903-06 (K. Murphy). This is not evidence that the “market rate” is below the statutory rate. K. Murphy WRT (CO Trial Ex. 400) at 17; 5/15/08 Tr. at 6903-06 (K. Murphy). Professor Murphy further explained that even though there are songwriters who are not subject to controlled composition clauses who agree to controlled rates when their songs will be on albums by artists who are bound by such clauses, “the fact that songwriters enter into such

agreements is not evidence that the statutory mechanical rate exceeds the market rate.”

K. Murphy WRT (CO Trial Ex. 400) at 17.

681. What economics and the evidence show is that the effective rate is not a market rate but rather a rate that is derived from and dependent upon the statutory rate. *See* 5/12/08 Tr. at 5893 (Wildman); 5/15/08 Tr. at 6903-06 (K. Murphy). As a result, it is an inappropriate benchmark for setting the statutory rate.

(i) The Statutory Rate and Effective Rate Are Interrelated

682. Professor Wildman conceded on cross-examination that the effective rate “is not independent of the statutory rate.” 5/12/08 Tr. at 5893 (Wildman). That is because the negotiations below the statutory rate that yield the effective rate “take place in the context of the overhang of the statutory rate.” *Id.*

683. Professor Wildman’s concession in and of itself undermines his argument that the effective rate provides marketplace evidence of the appropriate level for the mechanical royalty rate. Wildman WRT (RIAA Trial Ex. 87) at 37-42. The fact that copyright users are able to negotiate mechanical license fees below the statutory rate—because of the application of controlled composition clauses or for other reasons—does not transform those negotiated rates into an independent market rate that can serve as a benchmark in this proceeding.

(ii) Controlled Composition Rates Are Not Market Rates

684. The principal reason that the effective rate is below the statutory rate is that many mechanical licenses are issued under controlled composition clauses. *See* Wildman WRT (RIAA Trial Ex. 87) at 39-41. These clauses, contained in recording agreements between record companies and artists, reduce the amount of mechanical

royalties payable for songs written during the term of the agreement. K. Murphy WRT (CO Trial Ex. 400) at 14; *see also* Landes WDT (CO Trial Ex. 22) at 30 n.16. The clauses typically contain two provisions that effect this reduction: (1) a discounted mechanical rate denominated as a percentage of the statutory rate (typically 75%); and (2) a cap on the number of songs for which mechanicals will be paid (typically 10-12 per album). K. Murphy WRT (CO Trial Ex. 400) at 15; *see also* Landes WDT (CO Trial Ex. 22) at 30 n.16.

685. For a number of reasons, the rates resulting from controlled composition clauses cannot serve as a marketplace benchmark to determine a reasonable statutory rate.

(1) Controlled Composition Clauses Are the Result of Trade-Offs

686. A controlled composition clause is just one element of an artist contract. *See* Landes WRT (CO Trial Ex. 406) at 35-36; CO Trial Ex. 297; CO Trial Ex. 56. The mechanical license rate set out in controlled composition clauses is the result of trade-offs between other components of the agreement rather than an independent rate. *See* Landes WRT (CO Trial Ex. 406) at 35-36; Murphy WRT (CO Trial Ex. 400) at 15-16; Teece WDT (CO Trial Ex. 64) at 29. That is because artist contracts are complicated, multi-part agreements covering a wide variety of rights. *See* Landes WRT (CO Trial Ex. 406) at 35. Sony Music's template artist contract, for instance, is a complex, 75-page agreement that covers, among other things, [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED] *See* CO

Trial Ex. 297. A template contract for labels of Warner Music Group covers similarly broad territory, including the [REDACTED]
[REDACTED]
[REDACTED]. See CO Trial Ex. 56 at RIAA 45264-65, 45270, 45272.

687. Economists for both the Copyright Owners and the RIAA testified to this point. The RIAA's initial expert, Professor Teece, stated: "Economic theory suggest [*sic*] that artist-songwriter [*sic*] would agree to [a controlled rate] only in exchange for other financial benefits, such as a higher 'advance' payment or a higher artist royalty rate." Teece WDT (CO Trial Ex. 64) at 29. Professor Wildman concurred, noting that that controlled composition clauses are embedded in artist agreements containing a "package of rights." 5/12/08 Tr. at 5892 (Wildman). As did Professor Landes: "[f]rom an economic standpoint, one cannot examine a single term from a package agreement that governs such a variety of issues, because parties to such agreements make trade-offs between various aspects of the agreement in order to reach a final arrangement." Landes WRT (CO Trial Ex. 406) at 35. Professor Murphy also explained that controlled composition rates cannot be viewed in isolation because the parties to the artist agreements containing the controlled composition clauses are concerned with "the total compensation package," not optimizing each individual term. K. Murphy WRT (CO Trial Ex. 400) at 15-16.¹¹

¹¹ The fact, for instance, that employers provide "free" or low-priced health insurance to their employees as part of their compensation packages does not imply that the "market rate" for health insurance is the price paid by the employee. K. Murphy WRT (CO Trial Ex. 400) at 16.

688. The economists' testimony is supported by marketplace evidence given by Mr. Faxon. He explained that recording artists have "a number of objectives" when negotiating their contracts, including not just the desired level of their artist and mechanical royalties but also, among other things, their advances and marketing commitments. 5/14/08 Tr. at 6412-13 (Faxon). Mr. Faxon testified that there are "lots of other consideration[s]" that artists have when negotiating their contracts. *Id.* at 6413.

689. As a result, mechanical rates set pursuant to controlled composition clauses do not constitute independent market rates that can be used as a benchmark for determination of the statutory rate.

**(2) Professor Murphy's Empirical Study
Disproves the Claim That Controlled
Composition Clauses Should Be Used as a
Benchmark**

690. Professor Murphy provided further evidence undermining the notion that controlled composition rates should be employed in setting a statutory rate. His study of controlled composition rates demonstrated that the rates set out in controlled composition clauses are, in fact, derivative of the statutory rate and, therefore, provide no evidence of an independent market rate. K. Murphy WRT (CO Trial Ex. 400) at 14-17.

691. Professor Murphy analyzed 86 artist contracts spanning the years 1953 to 2007 that were produced by EMI Music in this proceeding. *Id.* at 14. These were the only executed contracts produced by the RIAA. 5/15/08 Tr. at 6908-09 (K. Murphy).

692. To test the RIAA's hypothesis that controlled rates were indicators of a market rate, Professor Murphy analyzed the relationship over time between the statutory rate and the controlled rates denominated in the artist contracts. K. Murphy WRT (CO Trial Ex. 400) at 14-17; 5/15/08 Tr. at 6908-17 (K. Murphy). As Professor Murphy

explained, if the controlled rate represented a market rate, the percentage reduction or cap on compensable songs contained in controlled composition clauses should have adjusted downward as the statutory rate rose. K. Murphy WRT (CO Trial Ex. 400) at 16. This has not occurred. To the contrary, the controlled composition rate in EMI's artist contracts has remained relatively fixed at 75 or 100% of the statutory rate. *Id.* at 16. The caps in controlled composition clauses (the maximum number of songs for which record companies pay mechanical royalties) have also held steady at 10-12 songs per album. *Id.* at 15-16. Because the rates and caps have remained fixed over a period of time when the statutory rate has increased, Professor Murphy concluded that the rates in controlled composition clauses are not indicative of an independent market rate for mechanical rights. *Id.* at 14-17. The results of Professor Murphy's study show that, far from controlled composition rates reflecting some sort of market trend or rate, they are simply derivative of the statutory rate.

693. Testimony from the RIAA confirmed Professor Murphy's analysis. Ms. Finkelstein of Sony BMG acknowledged that if this Court accepted the RIAA's proposal for a rate reduction, her company's controlled composition rate "would just be pegged to the new statutory rate." 5/12/08 Tr. at 5744 (A. Finkelstein). The RIAA has provided no evidence demonstrating that other record companies would not follow suit by continuing to use controlled composition clauses to reduce further the statutory rate. Thus, as Professor Murphy's study shows, new controlled composition clauses would simply be tied to the new, *lower* statutory rate—further depressing what the RIAA claims is the independent "market rate" for mechanical rights.

(b) The “First Use” Benchmark Is Not Appropriate

694. The record evidence indicates that like the effective rate, first use rates are derivative of the statutory mechanical rate. Professor Wildman’s argument that fees paid for first uses of songs provide a market benchmark for setting the statutory rate, Wildman WRT (RIAA Trial Ex. 87) at 42-44, is incorrect. Professor Wildman views these rates as appropriate benchmarks because first uses are not subject to compulsory licensing. *Id.* at 42. He concludes that, because average first use rates are below the statutory rate, this “marketplace” evidence leads to the conclusion that the current statutory rate is above the market rate. *Id.* at 42-44.

695. Professor Wildman’s conclusion is undermined by his concession that the first use rate is derivative rather than independent of the statutory rate. 5/12/08 Tr. at 5894 (Wildman) (first use rates are “influenced by the statutory rate”). The principal reason for this, as Professor Wildman observed, is that first use songs compete for, and can be substituted by, songs that are available through mechanical licenses at the statutory rate. *Id.* at 5827. This testimony undermines any claim that the first use rate is an independent market rate.

696. Professor Wildman’s concession is consistent with the testimony of Professor Landes, who rejected the use of first use licenses as a market benchmark for just those reasons. Landes WRT (CO Trial Ex. 406) at 40. As he stated, “[a]s a practical matter, Copyright Owners would find it difficult to price their first-use licenses above the statutory rate, because the statutory compulsory licensing scheme ensures that buyers will always have large numbers of potential substitute songs to choose from that can be acquired at or below the statutory rate.” *Id.*; see also 2/11/08 Tr. at 2387 (Landes). The relationship between first use and statutory rates is underscored by the fact that, as with

respect to rates set by controlled composition clauses, first use licenses are frequently set at a percentage of the statutory rate. 5/12/08 Tr. at 5895-96 (Wildman).

697. Another reason why the first use rates cannot be a market benchmark is that such rates are often set pursuant to controlled composition agreements. 5/12/08 Tr. at 5894-95 (Wildman); *see also* Faxon WRT (CO Trial Ex. 375) at 13 (explaining that first use licenses are typically contained in contracts with controlled composition clauses). For the reasons set out above, *see supra* XV.B.3.a.ii, rates dictated by controlled composition clauses cannot constitute evidence of the market rate. *See also* Landes WRT (CO Trial Ex. 406) at 39-40.

698. The incentives of songwriters licensing songs for first use also undermines the use of these rates as a market benchmark for the statutory rate. Mr. Faxon explained that when songwriters negotiate first use license rates, “the rate almost invariably will be at the statutory rate because, at that point, the songwriter’s main objective is to get the song into the marketplace so he or she can realize future earnings.” Faxon WRT (CO Trial Ex. 375) at 13. Professor Landes similarly testified that the rate set for first uses will often be set with an eye towards generating income from subsequent uses. Landes WRT (CO Trial Ex. 406) at 41; *see also* 2/11/08 Tr. at 2387-88 (Landes). By definition, a rate that is calibrated to encourage future use is not an appropriate benchmark for the statutory rate.

(c) Professor Wildman’s Empirical Work is Deficient

699. Even if, contrary to the weight of the testimony and economic theory, effective and first use rates could comprise market benchmarks for the statutory rate, the rates derived by Professor Wildman are entitled to no weight because the empirical work that he performed to derive those rates is flawed in critical respects.

700. To determine the effective rate, Professor Wildman analyzed licensing data from three record companies, Sony BMG, Warner, and Universal, and two publishers, BMG and UMPG. *Id.* at 37-39. He employed data from the three record companies to calculate first use rates. *Id.* at 42-43. And he analyzed data from two of the record companies, Sony BMG and Warner, to determine first use rates paid to co-writers who had received controlled rates and individuals not subject to a controlled composition clause. *Id.* at 43-44. Based on these observations, he concluded that “the estimates for the various average effective rates ranged from a low of 5.25 cents to a high of 7.8 cents.” *Id.* at 44. The evidence in the record regarding the shortcomings of Professor Wildman’s empirical work counsels against giving it any weight.

701. Professor Wildman conceded that he could not opine on the representativeness of the limited data he analyzed from any of the record companies. *See* 5/12/08 Tr. at 5922-23, 5928-29, 5933 (Wildman). In the case of Sony BMG and Warner, he received data from only one quarter in 2006. Wildman WRT (RIAA Trial Ex. 87) at 35. His data from Universal spanned a larger time period but still only covered two years—2006 and 2007. *Id.* at 36. That these data cover very different time periods makes it difficult to perform any comparisons between companies. 5/12/08 Tr. at 5844-45 (Wisniewski, J.). Professor Wildman conducted no interviews of any record company executives that would aid him in such comparisons. *See* 5/12/08 Tr. at 5910-11, 5928 (Wildman).

702. The limited time period for which Professor Wildman collected data precluded a time-series analysis to assess whether effective mechanical and first use rates have, in fact, been rising over time. *See id.* at 5908-09 (Wildman). As Professor Murphy

explained, even assuming effective rates are useful measurements for the purposes of setting a statutory rate, the critical question is “whether the gap between the statutory rate and the average transaction price is widening or narrowing.” 5/15/08 Tr. at 6906-07 (K. Murphy). Professor Wildman’s data allowed for no such analysis. 5/12/08 Tr. at 5908-09 (Wildman).

703. Moreover, although Professor Wildman presented his findings with respect to mean rates, he failed to provide an analysis of median values. *See* Wildman WRT (RIAA Trial Ex. 87) at 37-44; 5/12/08 Tr. at 5918-19, 5932-33 (Wildman). A median, as Professor Landes explained, “is the value that divides the data so that half the observations are on one side, half on the other. The median is not affected by extreme values in the data, as the mean can be.” Landes WRT (CO Trial Ex. 406) at 8 n.10.

704. The evidence suggests that Professor Wildman’s means analyses were corrupted by just this flaw. His testimony revealed that a substantial amount of licensing activity occurred at the statutory level: In the case of the Universal data, Professor Wildman found that 67% of licenses were at the statutory rate, indicating that the median effective rate was 9.1 cents. 5/12/08 Tr. at 5998-99 (Wildman). But he reported only a mean overall effective rate of █████ cents. Wildman WRT (RIAA Trial Ex. 87) at 38.

705. In addition, Professor Wildman’s testimony concerning mean rates fails to adjust for the impact of controlled composition clauses. *See* 5/12/08 Tr. at 5916, 5926-27, 5931-32 (Wildman). Although he presented information for co-writers who accepted reduced rates even though they were not themselves subject to controlled composition clauses, Professor Wildman could not say whether any of those co-writers received additional remuneration, such as advances, in exchange for their agreement to take

reduced rates. *See id.* at 5921-22, 5927-29 (Wildman). Professor Wildman knew, however, that such payments are often made in the business. *Id.* at 5921. The failure to account for such other consideration undermines the conclusions that he attempted to draw.

706. Taken together, these shortcomings of Professor Wildman's empirical work counsel strongly against using it to set a statutory rate. Professor Wildman's data were limited, and his analysis lacked appropriate rigor and attentiveness to the relevant marketplace dynamics.

(d) Professor Wildman Did Not Appropriately Examine the RIAA's Rate Proposal And Cannot Fully Endorse It

707. Professor Wildman performed no analyses to support the RIAA's percentage of revenue proposals. Although in his written testimony he purported to find the RIAA's 9 percent of wholesale rate to be reasonable, Professor Wildman in fact performed no calculations based on a percentage of revenue. 5/12/08 Tr. at 5882-83 (Wildman). He simply relied on the representation given to him by counsel for the RIAA that 9 percent of wholesale translated into 6.5 cents. *Id.* at 5883-84. Nor did he give any consideration of the adequacy of the revenue base proposed by the RIAA. *Id.* at 5884.

708. Finally, although Professor Wildman opined that a rate of 6.5 cents was "reasonable and well-justified," Wildman WRT (RIAA Trial Ex. 87) at 6, he conceded that higher rates than those proposed by the RIAA would be reasonable as well. He specifically conceded that a rate of 7.8 cents would not be unreasonable. 5/12/08 Tr. at 5885-86 (Wildman). Nor did he rule out that a rate higher than 7.8 cents would be reasonable, too, admitting that he could not conclude as an economist that 7.8 cents was the upper bound of a reasonable statutory rate. *Id.* at 5886-87.

4. International Rates Are Not Appropriate Benchmarks

709. In addition to the benchmarks sponsored by its economists, the RIAA has asserted that mechanical royalty rates in the United Kingdom and Japan provide another benchmark for reducing the statutory rate. *See* Taylor WDT (RIAA Trial Ex. 53) at 7; Boulton WDT (RIAA Trial Ex. 54) at 21-22.

710. The RIAA's reliance on rates in the U.K. and Japan is flawed at every level. Its rebuttal economist, Professor Wildman, has refused to endorse the RIAA's position. 5/12/08 Tr. at 5987-88 (Wildman). There has been a failure of proof as to the comparability of U.K. and Japanese mechanical licensing; in the absence of such a showing, the rates in those countries have no meaning whatsoever as a benchmark for the statutory rate. And, as shown through the rebuttal testimony of Mr. Fabinyi, full consideration of international rates, not just those cherry-picked by the RIAA, lends no support at all for the proposition that the statutory rate needs to be lowered to bring it in line with mechanical rates around the world. *See* Fabinyi WRT (CO Trial Ex. 380) at 10, Exs. F-1, F-2.

711. The RIAA attempted to make its case for comparability through the testimony of Mr. Taylor, the chief executive of the RIAA's British counterpart. Taylor WDT (RIAA Trial Ex. 53) at 1 (asserting that there are "important similarities between the U.S. recording industry and the recording industries in the U.K. and, to a lesser extent, Japan."). But the record evidence reveals a significant number of fundamental differences in mechanical licensing in the three countries that undermine Mr. Taylor's conclusion. Fabinyi WDT (CO Trial Ex. 380) at 4-9; Teece WDT (RIAA Trial Ex. 64) at 114.

712. Many of these distinctions were pointed out in the rebuttal trial by Mr. Fabinyi, a knowledgeable music industry veteran who has held senior positions in organizations responsible for the licensing of mechanical and other rights around the world. Fabinyi WRT (CO Trial Ex. 380) at 2-3; 5/15/08 Tr. at 6704-10 (Fabinyi). As he testified, the United Kingdom, unlike the United States, has no compulsory license for mechanical royalties. 5/15/08 Tr. at 6789 (Fabinyi). Indeed, the RIAA's expert, Professor Teece made the same point: "there is no U.K. analogue of the compulsory license that exists under U.S. law." Teece WDT (RIAA Trial Ex. 64) at 114 n.158. Likewise, while there are provisions in Japanese law for a compulsory license, these provisions have never been implemented and, as a result, in Japan the mechanical royalty rate is set pursuant to industry agreement. 5/15/08 Tr. at 6802 (Fabinyi). There is no evidence that Mr. Taylor's observations about the comparability of the three markets took account of this critical distinction.

713. Second, the mechanical royalty scheme in the U.S. is distinct from the U.K. and Japan because of the prevalence of controlled composition clauses. Fabinyi WRT (CO Trial Ex. 380) at 6. In stark contrast, in the U.K. any controlled compositions clauses that exist in individual agreements are expressly overridden by industry agreement, the AP.1 Agreement for the Manufacture and Distribution of Records for Retail Sale to the Public for Private Use, which governs the retail distributions of large record companies. *See* Fabinyi WRT (CO Trial Ex. 380), Ex. A; 5/15/08 Tr. at 6713, 6793-6794 (Fabinyi). Article 3 of the AP.1 Agreement, which is entitled "Overriding of Controlled Composition," "works by making the Scheme override any other royalty arrangement which may have been in place." RIAA Trial Ex. 53, Ex. D-105-DP at 25;

see also 2/12/08 Tr. at 2832-33 (Taylor) (acknowledging the unenforceability of controlled composition clauses in the U.K.). Identical language is contained within Article 3 of two other U.K. industry agreements—AP2 and AP2A Agreements—that govern smaller record companies. *See* Fabinyi WRT (CO Trial Ex. 380), Exs. B, C; 5/15/08 Tr. at 6714 (Fabinyi).

714. Indeed, prior ratemaking proceedings in the U.K. have pointed to the existence of controlled compositions clauses as a reason why the U.K. tribunal should not look to the U.S. in setting U.K. mechanical rates. In its 1991 decision approving Article 3, the U.K. Copyright Tribunal observed that controlled composition clauses in the United States are “not uncommon,” may “affect the effective rate” in the U.S., and that this “is one reason for not placing substantial reliance” on the U.S. rate in determining the U.K. rate. RIAA Trial Ex. 53, Ex. D-105-DP at 25-26.

715. Therefore, in the U.K., the royalty rates for physical product and digital downloads serve as the *effective rates*. 5/15/08 Tr. at 6789-6791 (Fabinyi). By contrast, because of the prevalence of controlled composition clauses and the ability to bargain underneath the statutory rate, *see supra* XIII, in the U.S. the statutory mechanical rate serves as the functional equivalent of a ceiling. 5/15/08 Tr. at 6791 (Fabinyi). (In the U.S., controlled composition clauses do not apply to digital downloads for recordings that are incorporated in contracts entered after June 22, 1995. 17 U.S.C. § 115(c)(3)(E)(ii)(1).) Rates in continental European countries are similar in nature to the rate in the U.K. in that they function as the effective rate rather than as a ceiling. *See* Fabinyi WRT (CO Trial Ex. 380) at 6; Ex. D at Article I (3).

716. Third, the RIAA's comparison of U.S. and U.K. rates as percentage of wholesale (in the U.S.) and Published Price to Dealer, or "PPD" (in the U.K.) is flawed, because "wholesale" in the U.S. is calculated in a very different manner from PPD in the U.K.

717. In the U.K., PPD is defined as the highest price a retailer would be willing to pay for the fewest number of copies in the absence of discounts, incentives, bonuses, reductions or deductions. Fabinyi WRT (CO Trial Ex. 380) at 7; *see also id.*, Ex. A at 1.15; 5/15/08 Tr. at 6796-6799 (Fabinyi). As Mr. Fabinyi testified, discounting prior to the calculation of PPD can be as high as 40%. Fabinyi WRT (CO Trial Ex. 380) at 7; 5/15/08 Tr. at 6797 (Fabinyi). Mr. Boulton, the expert witness offered by the RIAA in an effort to translate U.K. rates, acknowledged that "PPD is not the equivalent of a wholesale price, as it does not take into account any other discounts offline retailers receive." Boulton WDT (RIAA Trial Ex. 54) at 8. Indeed, PPD in the U.K. is not even calculated consistently with PPD in other European countries. Fabinyi WRT (CO Trial Ex. 380) at 7.

718. "Wholesale revenue," as that term is proposed to be defined by the RIAA, is a totally different revenue base than PPD. The RIAA's proposal defines wholesale revenue for physical products directly sold by a record company to a distributor as sales revenue *less returns and applicable sales discounts*. RIAA Amended Proposal at 2 (emphasis added); *see also* 5/15/08 Tr. at 6796-6797 (Fabinyi). Because of the significance of returns and discounts, wholesale revenue is by definition a much narrower rate base than PPD. *See* 5/15/08 Tr. at 6797-98 (Fabinyi). Thus, it makes no sense

whatsoever to compare a percentage of PPD with a percentage of wholesale revenue without reconciliation of the two revenue bases.

719. The RIAA also presented the testimony of Mr. Boulton, who testified about the settlement of a litigated proceeding concerning online rates in the U.K. that culminated in what is known as the New Joint Online License, or New JOL.¹² Mr. Boulton attempted to bolster the RIAA's proposed rate by claiming that the 7.8 percentage rate proposed by the RIAA in its direct case closely corresponded to the U.K. online rate. Boulton WDT (RIAA Trial Ex. 54) at 21-22.

720. But Mr. Boulton's testimony was inconsistent with his prior testimony in a U.K. proceeding. There, he stated: "international royalties are of limited usefulness in determining a reasonable royalty [in the U.K.]," 2/13/08 Tr. at 2977 (Boulton), and that "the use of such comparisons must take into account a variety of international differences. Music may be valued differently in different countries as a result of the various roles which particular types of music assume in the society." *Id.* at 2979 (Boulton). Neither Mr. Boulton nor any other witness for the RIAA attempted to account for those differences.

721. In fact, there are fundamental and significant differences in the recorded music markets in the U.S., U.K. and Japan. The U.K. is a relatively small market. 5/15/08 Tr. at 6800 (Fabinyi). In 2006, the wholesale U.K. recorded music market was

¹² In the U.K., on September 28, 2006, the Mechanical-Copyright Protection Society Limited ("MCPC") and Performing Right Society Limited ("PROS"), which represent copyright owners, the British Phonographic Industry Limited, which represents record companies, and various music service providers and mobile network operators reached an agreement to settle a reference to the U.K. Copyright Tribunal regarding the license terms for the supply of musical compositions online. *See* RIAA Trial Ex. 53, Ex. D-106-DP.

approximately \$2 billion dollars. CO Trial Ex. 29 at CO 9008788. The wholesale U.S. recorded music market was approximately \$6.5 billion. *Id.* at CO 9008767. In addition, the U.S. and U.K. are large exporters of music, while Japan is a closed, domestic market. 5/15/08 Tr. at 6803 (Fabinyi). Approximately 85% of the music market in Japan consists of Japanese music. Fabinyi WRT (CO Trial Ex. 380) at 9; 5/15/08 Tr. at 6803 (Fabinyi). The RIAA offered no testimony that would take into account these market distinctions.

722. Mr. Fabinyi also rebutted Mr. Taylor's assertion that the U.S. has "one of the highest" mechanical royalty rates in the world. His analysis shows that the current U.S. statutory rate for physical product is well in line with mechanical rates around the world when those rates are compared on a currency adjusted basis. Indeed, the evidence shows that the U.S. rate lags well behind that of most European countries:

Physical Rates

Country	Mechanical Rate	Average PPD¹	Average # tracks	Effective royalty per track	Exchange Rate²	Royalty per track in U.S. \$
U.S. ³	N/A	N/A	N/A	N/A	N/A	0.091
Canada	N/A	N/A	N/A	CAD 0.081	0.977	0.079
Austria	9.009%	€ 12.50	14	€ 0.080	1.559	0.125
Denmark	9.009%	DKK 98	12	DKK 0.736	0.209	0.154
Finland	9.009%	€ 12.50	12	€ 0.094	1.559	0.147
France	9.009%	€ 11.07	15	€ 0.066	1.559	0.103
Germany	9.009%	€ 12.00-13.00	12-15	€ 0.072-0.098	1.559	0.112-0.153
Ireland	8.500%	€ 11.4225	12	€ 0.081	1.559	0.126
Japan	6.000%	¥2500-3000 ⁴	10-12	¥12.5-18.0	0.010	0.125-0.180
Netherlands	9.009%	€ 12.00	12	€ 0.090	1.559	0.140
Norway	9.009%	NOK 110	12	NOK 0.826	0.1925	0.159
Spain	9.009%	€ 12.00-13.00	11-12	€ 0.090-0.106	1.559	0.140-0.165
Sweden	9.009%	SEK 110	12	SEK 0.826	0.1659	0.137
Switzerland	9.009%	CHF 18.85	12.5	CHF 0.136	0.9876	0.134
UK	8.500%	£ 7.79	12	£ 0.055	1.976	0.109

¹ “Published Price to Dealer” for a full-price CD, less VAT.

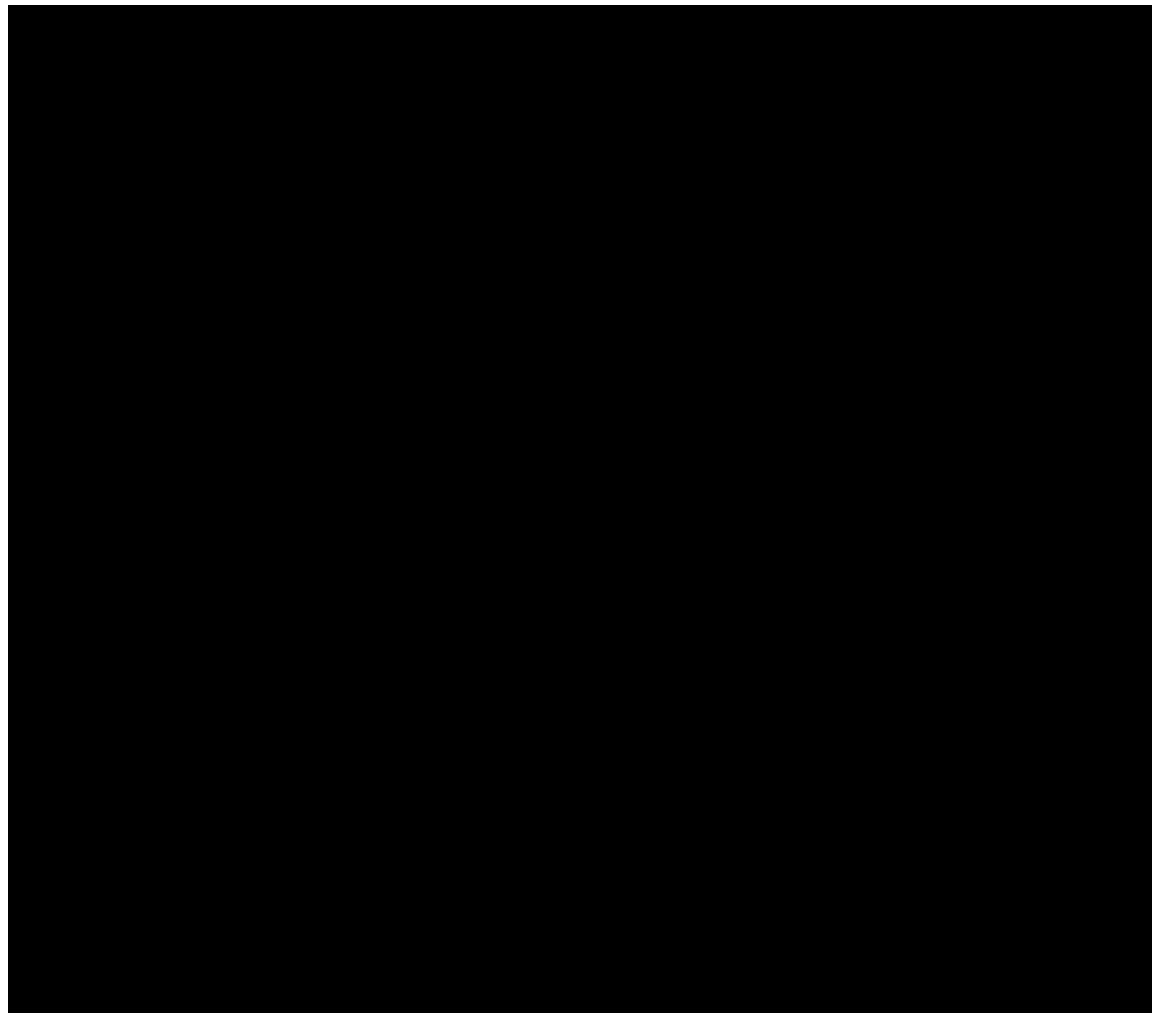
²Source: XE Currency Data Feed Source, as of April 1, 2008, www.xe.com.

³ Includes widespread use of controlled composition clauses.

⁴ Retail price.

Fabinyi WRT (CO Trial Ex. 380), Ex. F-1.

723. Mr. Fabinyi’s analysis of digital rates similarly shows that a number of European countries have mechanical rates in excess of the current statutory rate:



Fabinyi WRT (CO Trial Ex. 380), Ex. F-2.

724. The RIAA’s effort to minimize the comparison between U. S. and European rates relies on Mr. Taylor’s claim that mechanical royalty rates in those are “unilaterally promulgated” by the relevant collecting societies. RIAA Tr. Ex. 53 at 15. The evidence is to the contrary. The current European rate was established as a result of the 1998 BIEM/IFPI Agreement. *See* Fabinyi WRT (CO Trial Ex. 380), Ex. D. That rate, and that Agreement, were not “unilaterally promulgated” by one side or the other. Moreover, in almost every, if not every, European country there is a court, arbitration

body, tribunal or other form of independent dispute resolution to which one side or the other can go to resolve disagreements and prevent a rate from being “unilaterally promulgated.” 5/15/08 Tr. at 6806-07 (Fabinyi). As in the U.S., there are also laws against anti-competitive behavior in Europe, which also prevent the unilateral promulgation of rates. 5/15/08 Tr. at 6806-07 (Fabinyi).

725. In short, there is no evidence to support the international rate comparisons set forth by the RIAA. The RIAA’s principal economist on rebuttal has conceded he cannot support them as benchmarks, 5/12/08 Tr. at 5987-88 (Wildman), and the witnesses put forward by the RIAA ignored crucial distinctions between the relevant markets, including the absence of compulsory licenses in the U.K. and Japan and the prevalence of controlled composition clauses in the U.S., *see* Teece WDT (RIAA Trial Ex. 64) at 114 n.158; Fabinyi WRT (CO Trial Ex. 380) at 4-10. The only comprehensive analysis of international rates—conducted by Mr. Fabinyi—demonstrates not only that the rates urged upon this Court by the RIAA have been selectively chosen, but also that the mechanical royalty rate in the U.S. lags behind the rates in many other countries.

C. The Decline in CD Prices Does Not Support A Decline In The Mechanical Royalty Rate

726. Professor Murphy demonstrated that the RIAA’s assertion that the decline in CD prices should result in a reduction in the mechanical royalty rate is flawed. *See, e.g.*, Teece WDT (RIAA Trial Ex. 64) at 26-27. The suggestion that there should be a fixed relationship between CD prices and the mechanical royalty rate finds no support in economic theory or the relevant empirical evidence. K. Murphy WRT (CO Trial Ex. 400) at 4-14.

1. Economic Theory Undercuts the RIAA's Argument

727. As Professor Murphy explained, there is no self-evident relationship between the prices of inputs into a product and the supply and demand forces affecting that product. K. Murphy WRT (CO Trial Ex. 400) at 4. Market dynamics will affect the prices of inputs in different ways, and under conditions of falling prices for recorded music, economic theory in fact predicts that songwriters will receive an increasing proportion of revenue relative to other inputs from record companies. *Id* at 4-8. The RIAA's argument that mechanical license rates should fall as prices for recorded music fall is just the opposite of what economic theory would predict.

728. Professor Murphy began his explanation of the relevant economic theory by dividing the process of producing recorded music (or intellectual property more generally) into two steps: (1) the "creation" step and (2) the "distribution" step. *Id.* at 4; *see also* 5/15/08 Tr. at 6874-66 (K. Murphy). As an initial matter, "depending on the operative market forces, prices for the inputs supplied at the two steps will move in either the same or opposite directions." K. Murphy WRT (CO Trial Ex. 400) at 4; 5/15/08 Tr. at 6874-84 (K. Murphy).

729. The growth in digital distribution of music has fueled an increase in the consumption of music (including both legal and pirated consumption). At the same time, there has been a "decline in sales and prices of traditional distribution methods, such as recorded music delivered as CDs." K. Murphy WRT (CO Trial Ex. 400) at 5; 5/15/08 Tr. at 6873 (K. Murphy). Professor Murphy observed that the argument "that songwriters should receive *less* per song when the per-unit price of recorded music declines ignores the prediction from economic theory that greater relative supply of alternative distribution methods will *increase*, not reduce, the market-determined compensation of

songwriters and other inputs used to create the recordings relative to both record company compensation for distribution and the price of the final product.” K. Murphy WRT (CO Trial Ex. 400) at 5 (emphasis in original); 5/15/08 Tr. at 6882-84 (K. Murphy). As a result, “[a] benchmark based on a fixed ratio between the price paid to an input (songwriters) and the price of the output (recorded music) . . . is not an appropriate indicator of market values under such conditions.” K. Murphy WRT (CO Trial Ex. 40) at 6; 5/15/08 Tr. at 6883-84 (K. Murphy).

730. Similarly, a reduction in demand in an environment of falling prices will require a relative increase in compensation to songwriters in order to maintain the supply of songs. K. Murphy WRT (CO Trial Ex. 400) at 6-8; 5/15/08 Tr. at 6886-87 (K. Murphy). This is because songwriters, like recording artists, have “fixed” costs of production—*i.e.*, the costs incurred to create a single composition do not change based on the number of units sold. K. Murphy WRT (CO Trial Ex. 400) at 6. By contrast, the costs of inputs with “variable” costs of production, like those that go into the distribution step of producing recorded music, change based on the number of units sold. *Id.* at 6-7. As a result, the incentive to produce inputs with variable costs of production is principally affected by a reduction in prices, not the total amount of sales. The incentive to produce inputs with fixed costs of production, however, is affected by *both* a reduction in prices and the total number of units sold. K. Murphy WRT (CO Trial Ex. 400) at 7; 5/15/08 Tr. at 6886-87 (K. Murphy). Thus, Professor Murphy demonstrated that when sales decline, “an equal reduction in the per-unit payment for the fixed cost and variable cost inputs would create a disproportionate reduction in the incentive to supply

songwriting and other fixed-cost elements of the recording.” K. Murphy WRT (CO Trial Ex. 400) at 7.

731. As a result, economic theory predicts under these conditions that compensation per unit would need to rise for songwriters (and artists) but not for inputs with variable costs. K. Murphy WRT (CO Trial Ex. 400) at 8. Professor Murphy explained that “[i]n the present context,” with sales and prices falling, “in order to maintain the relative incentives to provide creative and distribution inputs, the relative compensation per recording for inputs in the creative step (including songwriters) must increase.” K. Murphy WRT (CO Trial Ex. 400) at 8. Because songwriters and artists primarily have fixed costs of supply, while record companies have both variable and fixed costs, economic theory dictates that compensation for the creative inputs should be increasing relative to record company compensation. *Id.*

2. Empirical Evidence Undercuts the RIAA’s Argument

732. The empirical evidence adduced at trial is consistent with and confirmatory of Professor Murphy’s explication of economic theory. *See generally* K. Murphy WRT (CO Trial Ex. 400) at 8-14. His review of the record industry’s costs over a 15-year period provides powerful empirical support for his opinion that a decrease in CD sales and prices should not result in a decrease in the mechanical royalty rate. *Id.*; 5/15/08 Tr. at 6887-99 (K. Murphy).

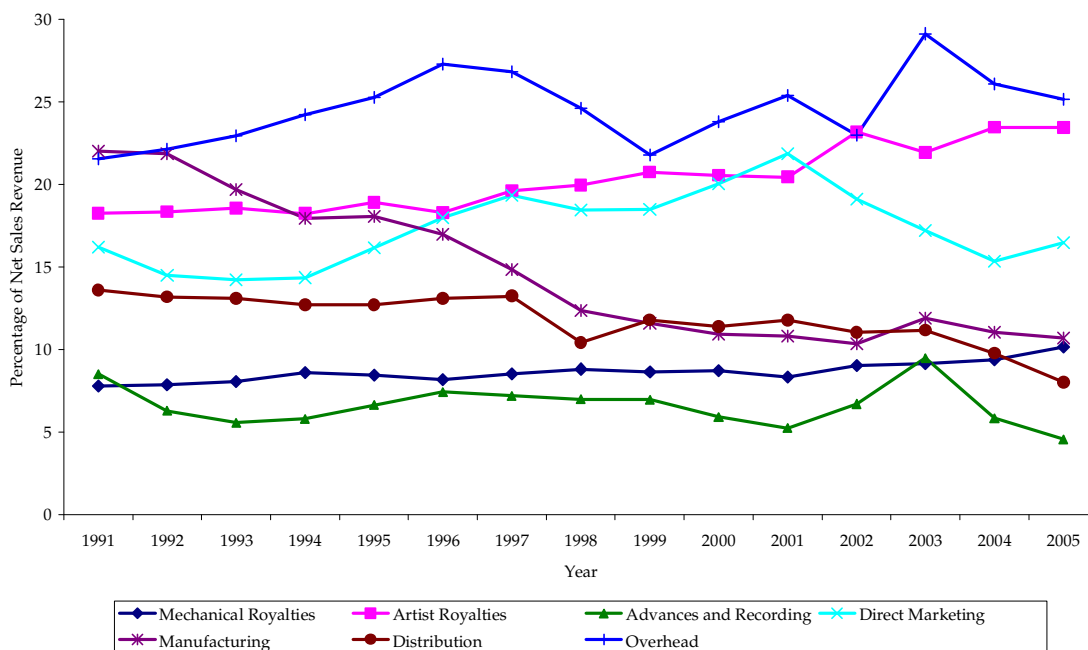
733. First, Professor Murphy examined the trend in compensation for recording artists. K. Murphy WRT (CO Trial Ex. 400) at 8-10; 5/15/08 Tr. at 6890-91 (K. Murphy). Unlike mechanical royalties, artist royalties are freely negotiated without the overhang of a compulsory license or a statutory rate. K. Murphy WRT (CO Trial Ex.

400) at 12.¹³ Because both songwriters and recording artists supply creative inputs, “the market-determined compensation of recording artists is likely to evolve in much the same way as market-determined compensation for songwriters.” K. Murphy WRT (CO Trial Ex. 400) at 9.

734. Professor Murphy’s findings were consistent with this prediction: the RIAA data showed that the percentage of the record companies’ costs and net revenue attributable to creative inputs had risen between 1991 and 2005. K. Murphy WRT (CO Trial Ex. 400) at 9; 5/15/08 Tr. at 6890-91 (K. Murphy). The figure below, from Professor Murphy’s Written Rebuttal Testimony, illustrates this trend.

¹³ During Professor Murphy’s oral testimony, Judge Wisniewski inquired as to whether the artist royalties in his study included royalties set pursuant to statute by rate-setting bodies, such as public performance royalties for satellite radio or webcasting. 5/19/08 Tr. at 7013-14 (Wisniewski, J.). The numbers Professor Murphy used were taken from the work of one of the RIAA’s experts, Linda McLaughlin. K. Murphy WRT (CO Trial Ex. 400) at 9. Ms. McLaughlin’s testimony provided no evidence to indicate that her artist royalties figures included royalties beyond those determined pursuant to recording contracts. *See* 2/13/08 Tr. at 3033-34 (McLaughlin) (referring to royalties received “by contract” as well as “things that [artists] have contractually agreed to have their royalties cover”). The recording agreements in evidence, from Sony BMG and Warner Music Group, indicate that [REDACTED]. *See* CO Trial Ex. 56 (WMG) at RIAA 45273, Section 9(h); CO Trial Ex. 297 (Sony BMG) at 30, Section 10.04. Thus, the available evidence indicates that Ms. McLaughlin’s numbers, and Professor Murphy’s analysis, both deal with artist royalties that are freely negotiated.

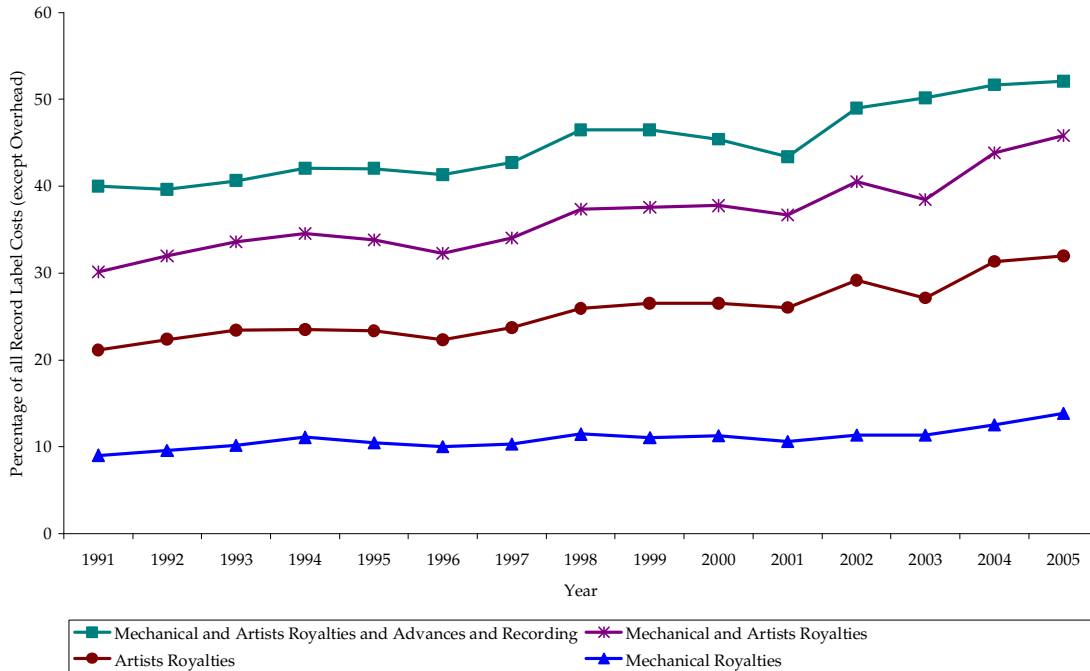
Record Label Costs for Intellectual Property have Increased Relative to Costs of Other Record Label Functions



Id. at 10. Put another way, declining CD sales and prices did not depress artist royalties; to the contrary, those royalties rose steadily throughout the period as a fraction of overall record company sales.

735. Professor Murphy also studied the trends in compensation to the creative inputs exclusive of overhead costs. K. Murphy WRT (CO Trial Ex. 400) at 10; 5/15/08 Tr. at 6894-95 (K. Murphy). The data show that artist and mechanical royalties had both increased as a share of non-overhead costs, as had the costs of royalties when combined with expenses for advances and recording (also creative costs):

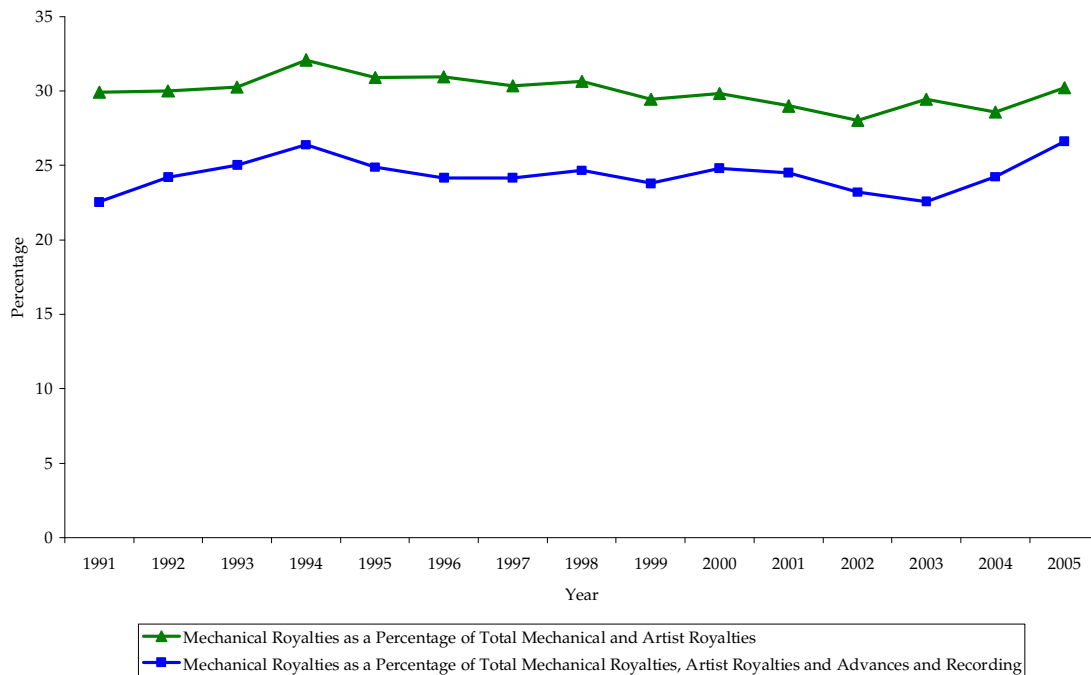
Intellectual Property Costs have Increased as a Percentage of All Record Label Costs



Id. at 10-11; 5/15/08 Tr. at 6894-95 (K. Murphy). From these data, Professor Murphy concludes: “This increase in the fraction of cost accounted for by intellectual property and artistic talents is what I would expect to observe if the more traditional record company functions associated with the production and sale of physical products (the second step in the [production] chain) are less important in the digital world.” K. Murphy WRT (CO Trial Ex. 400) at 10.

736. Finally, Professor Murphy demonstrated that, contrary to the RIAA’s claims, mechanical royalties had not gotten out of line with long-term historical trends. In fact, mechanical royalties had accounted “for a fairly constant percentage of total record label payments for artistic inputs (mechanical royalties, artist royalties and advances and recording costs), most of which the record labels negotiate directly with artists.” *Id.* at 11; *see also* 5/15/08 Tr. at 6897-98 (K. Murphy).

Mechanical Royalties Share of Intellectual Property Cost has been Stable over Time



K. Murphy WRT (CO Trial Ex. 400) at 12.

737. In short, both economic theory and empirical data demonstrate that the decline in CD sales and prices have not resulted in and should not support a reduction of mechanical royalties. *Id.* at 4-13; 5/15/08 Tr. at 6898-99 (K. Murphy).

D. The RIAA’s Claims About the Prospects of the Recording Industry Are Unsupported By Record Evidence

738. The RIAA has also advanced a grab bag of additional arguments concerning the state of the recorded music industry to support its claim that there needs to be a dramatic reduction in the statutory rate. The weight of the evidence does not support these arguments.

739. The most prominent claim is that the deteriorating financial condition of the record companies requires statutory rate relief. But the record does not comport with the argument. What the evidence shows is that the profitability of the record companies

is on the upswing. The RIAA's own analyses and documents show that the transition to online and mobile music formats has resulted in a dramatic reduction in costs that has driven profit margins to their highest levels in the past 15 years. Fact and expert testimony adduced at trial also demonstrates that the outlook for the future is even brighter as the recorded music industry continues its transition from distribution of physical products to higher-margin digital sales.

740. Unable to dispute that digital distribution carries higher profit margins than physical sales, the RIAA has attempted to muddy the waters by arguing that this increase in profitability has been achieved only as a result of a significant investment in digital infrastructure that must be taken into account in determining a reasonable statutory rate. In fact, the evidence fails to provide any meaningful support for such a claim. There was no shortage of conclusory testimony claiming that such investments were made. But there was a distinct absence of empirical proof to support it: not a single record company came forward with any quantitative evidence of such an investment.

741. The RIAA also argued that a cut in the statutory rate would actually be in the best interests of the record companies and Copyright Owners because they would invest the savings in the development of new artists and recordings. This argument, too, was exposed as entirely devoid of substance. The RIAA produced no evidence proving, or even supporting the inference, that a decrease in mechanical royalties would benefit any party other than the record companies.

742. Finally, the RIAA attempted to bolster its case for a reduction in statutory royalties through the testimony of executives of two independent labels, both of whom suggested that the failure to reduce mechanical rates would work a particular hardship on

non-major record companies. In the end, however, the evidence of neither witness was sufficient to support the RIAA's case.

1. The Record Companies' Financial Condition Is Healthy And Improving

743. Virtually all of the RIAA witnesses testified at greater or lesser length concerning the purported financial distress of the recorded music industry and the need to cut the statutory rate in response. Mr. Wilcox, a former executive at Sony BMG, testified that the recording industry had been hit by “a confluence of business conditions that have created intense pressure on margins and caused a contraction in the business that is unprecedented in history.” Wilcox WDT (RIAA Trial Ex. 70) at 5; *see also* 2/20/08 Tr. at 3938-39 (Wilcox). Mr. Finkelstein of EMI Music claimed that because of turmoil in the industry, most record companies were “only marginally profitable (if at all) on a domestic basis.” C. Finkelstein (RIAA Trial Ex. 57) at 4; *see also* 2/13/08 Tr. at 3110-26 (C. Finkelstein). Mr. Munns, a former executive at EMI Music, argued that “[t]he recording industry is going through the most profound and dramatic transition that I have seen in my more than thirty years in the business” and that “the marketplace is undergoing fundamental and permanent changes.” Munns WDT (RIAA Trial Ex. 76) at 2. Mr. Eisenberg testified that there was a “terminal decline in the physical product business,” Eisenberg WRT (RIAA Trial Ex. 89) at 4,” and that “the net impact of the physical decline continues to usurp gains made in the digital realm,” *id.* at 5. But the testimony of these record company witnesses is belied by the empirical evidence. That evidence shows that the industry is enjoying record levels of profitability and that the shift to online and mobile music platforms as the record companies' primary distribution channels will further boost the industry's financial position. *See supra* IX.C.

744. Although the record companies' top-line revenues have declined over the last decade, the evidence shows that overall profitability has increased. *See supra* IX.A, IX.C. Indeed, the evidence reveals that even as topline revenues have declined, record companies are developing new sources of revenue to offset this trend. *See supra* IX.A. These include concert promotion; "360 contracts" with artists entitling them to a share of artists' revenues in areas such as concerts and merchandise; performing rights royalties; synchronization royalties and artist/label joint ventures. *See id.*

745. The increased profitability of the record companies has been the result, in large measure, of decreases in manufacturing and distribution costs. *See supra* IX.B.2. This decline is primarily attributable to costs savings attendant in the shift in formats from CDs to online and mobile music providers.

746. The RIAA's own numbers prove the point. *See supra* IX.C. The analysis presented by Ms. McLaughlin shows that the profitability of the major record companies reached unprecedented levels in 2004 and 2005. *See id.*; CO Trial Ex. 41 at 1. Those profits were at a record high in both absolute terms—\$571 million in 2004, and \$740 million in 2006—and on a relative basis, when converted into operating margins of, respectively, 9.8% and 12.2%. *See supra* IX.C.

747. If anything, the McLaughlin numbers understate record industry profitability. Ms. McLaughlin, and her replacement on rebuttal, Mr. Benson, both excluded profits earned by the 30 percent of the industry not represented by the major record companies. Significantly, the McLaughlin and Benson analyses also excluded all of the profits earned by the manufacturing and distribution affiliates of major record companies. 2/13/08 Tr. at 3069-75 (McLaughlin); 5/8/08 Tr. at 5555 (Benson).

Universal's profit and loss statements indicate that [REDACTED]
[REDACTED]. CO Trial Ex. 264; *see also* 5/8/08 Tr. at 5555-56
(Benson).

748. Although Mr. Benson's numbers differ from Ms. McLaughlin's because of the record company's "discovery" between trials that the industry had incurred almost \$1 billion in costs that had escaped the attention of their longtime expert, Ms. McLaughlin, they do not alter the fundamental conclusion: record company profits are increasing both in absolute terms and measured by profit margin as digital sales increase. *See* CO Trial Ex. 41 at 1; H. Murphy WDT (CO Trial Ex. 15) at Exhibit 3A; Benson WRT (RIAA Trial Ex. 81) at 8; *see generally supra* IX.C.

749. In short, there is a mountain of evidence in the record contradicting conclusively the RIAA's claim that the record industry's dire financial straits require a reduction in the statutory rate.

2. The RIAA Has Failed To Demonstrate Significant Spending On Digital Infrastructure

750. The record is devoid of any empirical evidence to support the RIAA's conclusory assertions that the transition to more profitable digital distribution has required the infusion of significant capital that must be taken into account in setting the statutory rate. Mr. Kushner testified that the online business required "a huge investment in new infrastructure." Kushner WDT (RIAA Trial Ex. 62) at 4. Mr. Finkelstein of EMI has discussed the "large upfront investments" necessary to build the digital supply chain. C. Finkelstein WDT (RIAA Trial Ex. 57) at 18. Mr. Munns claimed that record companies have incurred "substantial" costs to service diversified distribution outlets and generate "significant" costs to maintain the distinct distribution chain for digital content.

755. Although Ms. Santisi spoke to chief financial officers at all four major record companies, none told her that a decline in the mechanical rate would lead to greater investments in artists and new recordings. *Id.* Likewise, no record company document purports to state that increased A&R expenditures would result from a cut in the statutory rate. *Id.* at 5184-85. Finally, none of the analyses conducted by Ms. Santisi demonstrated any correlation between the mechanical royalty rate and A&R spending. *Id.* at 5185.

756. In short, there is no evidence to suggest that a reduction in the mechanical royalty rate would lead to increased A&R spending, nor does the record support the claim that an increase in the mechanical rate would lead to a reduction in such spending.

4. Arguments by Independent Record Labels Do Not Support a Rate Cut

757. Although the lion's share of the RIAA's case focused on the major record labels, the RIAA did present the testimony of two independent record company executives in support of its argument for a decrease in the mechanical royalty rate. The evidence adduced by these two witnesses, Mr. Barros and Mr. Emmer, failed to provide any basis for adopting the RIAA's proposed rates. Mr. Barros presented a picture of a thriving independent record label that has nimbly adjusted to changes in the record industry marketplace. And while Mr. Emmer claimed that the current mechanical rate is impeding his ability to release compilation albums containing large number of tracks, his unique and most likely outdated business model is not one on which an industry wide rate can be set.

758. Mr. Barros's independent record company, Concord Records, is growing. Barros WDT (RIAA Trial Ex. 74) at 12, 25. From 2004 to 2006, Concord's record sales

increased by [REDACTED]. *See* CO Trial Ex. 83; 2/21/08 Tr. at 4167-68 (Barros). In August 2007, Concord estimated that its sales would increase [REDACTED] in 2007, with sales projected to increase [REDACTED] from 2004 to 2007. *See* CO Trial Ex. 83. Although Concord's mechanical royalty costs necessarily increased during this period of expansion, the [REDACTED] [REDACTED] was dwarfed by the label's [REDACTED] [REDACTED]. *See id.*; *see also* 2/21/08 Tr. at 4172-73 (Barros) (agreeing that publishing royalty costs increased less than marketing costs, which more than doubled in this period). Mr. Barros also conceded that his company had reaped the margin benefit of digital distribution: Concord's profit margins for digital downloads are higher than physical CDs. 2/21/08 Tr. at 4154 (Barros).

759. Digital distribution has improved the market position of independent labels such as Concord. As Mr. Barros conceded, "Technology has given consumers easier access to a wider range of recordings than has ever been possible before through download services, subscription services, and other kinds of new offerings. This is important for independent record companies like Concord that produce niche music, such as jazz, which doesn't get a lot of retail shelf space." Barros WDT (RIAA Trial Ex. 74) at 11. *Cf.* Cue WDT (DiMA Trial Ex. 3) at 23 (digital music services such as iTunes have expanded the breadth and diversity of musical works to which consumers are exposed and ultimately purchase—"thereby enabling publishers and music companies to 'exploit niche demand more effectively than ever before'").

760. Concord has also exploited new physical distribution channels to reach consumers through its partnership with Starbucks. Barros WDT (RIAA Trial Ex. 74) at

16; *see also* 2/21/08 Tr. at 4183 (Barros) (stating that “for records that get Starbucks treatment, I would agree it’s been incredibly effective”). The company’s success and prospects for the future are evidenced by two private equity investments since 1999. Tailwind Capital, a private equity firm, invested in Concord in 2004, and Act III Communications, a vehicle for Norman Lear, invested in the company in 1999. 2/21/08 Tr. at 4160-62 (Barros).

761. Mr. Emmer’s small label, Shout!, is a niche company that focuses almost exclusively on re-issues and compilations of previously-recorded and released songs. Emmer WRT (RIAA Trial Ex. 90) at 2. “[T]here is a case of us finding some new artists and releasing product by them as well. But that is not our strong suit by any means.” *Id* Importantly, in the context of current recorded music company market conditions, Mr. Emmer’s company does not release product digitally. Emmer WRT (RIAA Trial Ex. 90) at 6 n.3. The company is therefore limited to the small volume of physical product that it can release to a niche market of “audiophiles.” 5/13/08 Tr. at 6308 (Emmer). Although Mr. Emmer claims that he is unable to negotiate discounts from the statutory rate from music publishers, he acknowledged that the reason why is the small number of sales of his recordings. *See* 5/13/08 Tr. at 6269, 6287 (Emmer) (“[B]ecause of the volume that we’re projecting in our sales, which typically are less than 10,000 units . . . [music publishers] . . . are unwilling . . . to grant a reduced rate.”). His company is therefore not similarly situated to the large record companies led by the majors that comprise the overwhelming bulk of the recorded music business. The small size of his company similarly requires him to pay a higher price for physical distribution than his larger

competitors. Emmer WRT (RIAA Trial Ex. 90) at 5 ([REDACTED] distribution fee paid to Sony BMG for physical distribution).

762. In short, the testimony of Messrs. Emmer and Barros fails to provide any empirical support for the RIAA's proposed rates. It may well be that both independent labels would prefer a lower mechanical rate, but there is no evidence that their survival or that of independent record labels generally depends upon such a result.

E. The RIAA's Claims About Songwriters and Music Publishers Are Unsupported By Record Evidence

763. The RIAA has argued—repeatedly—that a reduction in the mechanical rate will not have any adverse impact on music publishers because music publishers are profitable and have other streams of income that will offset any reduction in the statutory rate.

764. In making this claim, the RIAA has appeared to lose sight of the fact that it is songwriters, not music publishers, who will be most adversely affected by the slashing of the statutory rate that the RIAA proposes. With the exception of Professor Slottje, each of the RIAA's expert and fact witnesses has failed to take into account the impact of a reduced rate on the individuals who write the compositions that the record companies record and sell. And Professor Slottje's theoretical consideration of incentives for songwriters is inconsistent with the record evidence, basic economics and common sense.

765. The RIAA has also attempted to justify its meager proposed rates by asserting that the contributions of songwriters and music publishers pale by comparison to the role of record companies in producing recorded music. These sometimes ad hominem arguments are belied by the substantial evidence adduced at trial concerning the

critical role of songwriters, whose personal and financial sacrifices lie at the root of the creative process responsible for recorded music. And the same arguments are advanced in contradiction to the mountain of evidence demonstrating the critical contributions made by music publishers in enabling songwriters to practice their craft. The old adage, it all begins with a song, appears to have been forgotten by the RIAA.

766. The RIAA's case also hinges upon its argument that the statutory rate should reflect the limited risk incurred by music publishers. The evidence is to the contrary: music publishers take meaningful risk, and songwriters even more. *See supra* IV.B-C, V.B.2. The relative risk of the parties provides no basis for lowering the statutory rate. Nor does the RIAA's related and unsupported argument that any reduction in the mechanical rate will be offset by other streams of income.

767. Finally, the RIAA claims that the Copyright Owners have taken a backseat in the fight against piracy. This assertion, too, is contradicted by the record.

1. The RIAA Has Ignored Songwriters Throughout This Proceeding

768. The evidence adduced by the RIAA has to be examined with a fine tooth comb to find any discussion of songwriters. Witness after witness for the RIAA has discussed the impact of a reduced rate on record companies and music publishers with scarcely a word said about the party whose interests are most directly affected by the outcome of this proceeding: songwriters. The RIAA's principal economists in both the direct and rebuttal trials submitted voluminous written testimony and presented oral testimony that was devoid of any substantive discussion of creative contributions of songwriters or the impact of the RIAA's proposed rate on their ability to continue to create new music. *See generally* Teece WDT (RIAA Trial Ex. 64); Wildman WRT

(RIAA Trial Ex. 87). Ms. Santisi, the RIAA's industry expert testified that she "did not study songwriters." 5/7/08 Tr. at 5208 (Santisi). Because she was "instructed" to leave songwriters out of her analysis, *id.* at 5207, Ms. Santisi assessed the purported impact of the 40 percent reduction in mechanicals sought by the RIAA on publishers without any consideration at all of how it would affect songwriters, *id.* at 5206-08.

769. The record shows that the RIAA's myopic view is misplaced because songwriters, not music publishers, are most heavily impacted by any reduction in the statutory rate. The uncontradicted evidence is that songwriters typically receive 75 percent (and sometimes as much as 95 percent) of mechanical royalty income. Peer WDT (CO Trial Ex. 13) at 6-7; 2/5/08 Tr. at 1650-51 (Peer); Robinson WDT (CO Trial Ex. 8) at 19; Faxon WDT (CO Trial Ex. 3) at 7. The Landes study confirms what the songwriter witnesses stated: many songwriters are heavily dependent mechanical royalties. *See supra* IV.C.2.e.iii. Inexplicably, the RIAA has failed to take this into account.

2. The RIAA's Arguments About Songwriters' Incentives Are Contradicted By The Record

770. The only RIAA witness to consider the impact of the statutory rate on songwriters was Professor Slottje, who advanced two theories unsupported by any empirical evidence in support of the RIAA's attempt to reduce the rate. First, Professor Slottje argued that a reduction in the mechanical rate will have little impact on the creation of new compositions because of the "attractive" non-pecuniary aspects of the songwriting profession. Slottje WRT (RIAA Trial Ex. 81) at 22-24. Second, Professor Slottje argued that because of the "tournament-type pay structure" that typifies the songwriting profession, the mechanical royalty rate can be reduced without any

meaningful adverse effects on the supply of songs. *Id.* at 24-26. There is no record support for either of Professor Slottje's theories.

(a) Hedonic Wage Theory Does Not Support a Rate Cut

771. Professor Slottje's argument concerning "hedonic wage theory" is contradicted by the evidence. According to Professor Slottje, "jobs that are risk-free (in terms of physical risk), offer substantial flexibility, or offer other non-pecuniary benefits (e.g. fame) can still attract sufficient numbers of workers even when paying low wages." Slottje WRT (RIAA Trial Ex. 81) at 23; *see also* 5/8/08 Tr. at 5334-36 (Slottje). Songwriting, in his view, is "a relatively pleasant, risk-free job (in terms of physical risk), with flexibility in terms of when and where to work." Slottje WRT (RIAA Trial Ex. 81) at 23; *see also* 5/8/08 Tr. at 5334-36 (Slottje). It also "offers other non-pecuniary benefits such as the opportunity to meet famous individuals, attend parties or award shows, as well as the 'warm-glow' feeling of hearing one's songs being performed." Slottje WRT (RIAA Trial Ex. 81) at 23; *see also* 5/8/08 Tr. at 5334-36 (Slottje). In Professor Slottje's theoretical world, all of these matters comprise "psychic income" and, as a result, "the wages being paid represent a small fraction of the overall compensation accrued by songwriters." Slottje WRT (RIAA Trial Ex. 81) at 23; *see also* 5/8/08 Tr. at 5334-36 (Slottje).

772. As described in the Copyright Owners Proposed Conclusions of Law, Section 801(b) does not contemplate that songwriters' "psychic income" will be factored into the consideration of what constitutes a fair return for the compulsory licensing of their work. More importantly, there is nothing whatsoever to support the application of Professor Slottje's theory.

773. None of the studies cited by Professor Slottje applied a hedonic wage theory to songwriter income. *See* Slottje WRT (RIAA Trial Ex. 81) at 22-24. Professor Slottje’s own work has never done so; he has never performed any academic work relating to the recorded music or songwriting industries. 5/8/08 Tr. at 5379 (Slottje). Although he is an econometrician, Professor Slottje attempted no econometric study in support of his theory to test his hypothesis that songwriters would be ambivalent to a material reduction in the statutory rate. *Id.* at 5380-81.

774. The testimony of the songwriters in this proceeding is all to the contrary. *See supra* IV.C. But prior to formulating his opinion and submitting his written direct testimony, Professor Slottje had given no consideration at all to that testimony. *Id.* at 5387-88 (Slottje). Had he reviewed that testimony, he would have discovered that songwriters do not view their jobs as easy. *See supra* IV.B. Rather, the act of creating a song is difficult and “incredibly labor intensive.” Carnes WDT (CO Trial Ex. 1) at 7.

775. Nor did the songwriters who testified suggest that they are more motivated by the “opportunity to meet famous individuals” than being paid fairly for their work. Rather, each of the songwriters explained the need for adequate financial compensation for their work and their desire for an increase in the mechanical royalty rate. *See supra* IV.C. Ms. Shaw, for example, testified that she was “scared” that her income would be reduced “further than it is.” 1/30/0 Tr. at 815 (Shaw).

(b) Tournament Theory Does Not Support a Rate Cut

776. Unable to dispute that the majority of songwriters earn modest income from their work, the RIAA has put forward a theory to justify this state of affairs. According to Professor Slottje, the songwriting profession is one dominated by a small number of “superstars,” who receive a significant amount of income, while the rest

receive “miniscule salaries.” Slottje WRT (RIAA Trial Ex. 81) at 24. Thus, he claims, the songwriter labor market can be explained by “tournament theory.” *Id.* at 24-25. According to Professor Slottje, “[a] large pay-off for a few success stories serves as motivation to all workers.” *Id.* at 25. As a result, “even if the mechanical rate is lowered or left at the current level, songwriters will still exist in large numbers and create numerous new works in an effort to be ‘discovered,’ and thus rewarded with such lucrative (monetary and non-monetary) pay-offs.” *Id.*

777. Tournament theory, as Professor Slottje conceded, is contrary to the most elementary principle of economics that supply increases with price. 5/8/08 Tr. at 5399-5400 (Slottje). Professor Murphy confirmed this basic proposition: “when the price goes up, people will supply more.” 5/19/08 Tr. at 6958 (K. Murphy). As Professor Landes explained, Professor Slottje’s reliance on tournament theory is wrong in two respects. First, efforts of people at the bottom of an income distribution will still be affected by a change in their compensation; if someone is making a small amount of money, an apparently modest increase “could indeed have a big effect.” 5/20/08 Tr. at 7344 (Landes). Second, the incentives of people at the bottom of the income distribution are affected by the level of pay that is available to someone who attains “superstar” status. Professor Landes explained that “increasing the income at the top is going to enhance the incentives of people at the bottom or in the middle.” 5/20/08 Tr. at 7346 (Landes). Those people at the bottom will “put more time and effort in the hope that they will be one of the people who are extremely successful at the top.” *Id.* at 7345.

778. The testimony from songwriters in this case also contradicts Professor Slottje’s claims. Those people all testified to the importance of mechanical royalties and

to the necessity of a rate increase to incentivize more songwriting. *See supra* IV.C. Not one songwriter suggested that the possibility of a hit was sufficient incentive irrespective of the statutory rate. Nor would it make sense for any songwriter to so testify. As Mr. Carnes, explained, even a big hit results in only a modest payoff in mechanical royalties. 1/28/08 Tr. at 205-08 (Carnes) (platinum selling song results in mechanical payment of approximately \$11,000).

3. The Copyright Owners Make Meaningful Contributions to the Production of Recorded Music

779. The RIAA's claims that the Copyright Owners do not contribute meaningfully to the creative process of creating music, *see, e.g.*, Kushner WDT (RIAA Trial Ex. 62) at 2; Munns WDT (RIAA Trial Ex. 76) at 16, is also belied by the overwhelming weight of the evidence.

780. Songwriters contribute an essential element to recorded music: the song itself. The record shows, as set out in Sections IV.B-C above, that songwriters make significant personal and financial sacrifices for their work. The work is labor-intensive, success is rare, and the financial rewards are modest. Rick Carnes, the President of SGA, testified that "the vast majority of professional songwriters live a perilous existence." Carnes WDT (CO Trial Ex. 1) at 3. The returns are so low, in fact, that many songwriters find it necessary to work additional jobs. *See id.* Steve Bogard, the head of NSAI, testified about an award-winning songwriter who had to sell handbags at a department store in order to generate additional income. Bogard WDT (CO Trial Ex. 2) at 8. And even the most successful songs provide only limited returns. *See supra* IV.C.1. For instance, Maia Sharp, a singer-songwriter who wrote a song that sold six million copies,

received just \$12,000 after her co-writer and publisher took their shares, and after her publisher recouped its advances. Sharp WDT (CO Trial Ex. 6) at 5-6.

781. Music publishers, too, play a critical role in the process of creating recorded music. Publishers are nothing like the passive recipients of royalties that the RIAA paints them to be. *See, e.g.*, Kushner WDT (RIAA Trial Ex. 62) at 2; Munns WDT (RIAA Trial Ex. 76) at 16. As explained more fully in Section V.B.2 above, music publishers expend many millions of dollars on A&R to find and nurture new songwriting talent. EMI MP's A&R staff, by itself, has [REDACTED]. [REDACTED]. Faxon WDT (CO Trial Ex. 3) at 6; *see also* 1/30/08 Tr. at 383-84 (Faxon). Publishers also provide essential financial support to songwriters in the form of advances. *See supra* I.B.2. Those commitments are substantial: Peermusic, for instance, often advances its writers hundreds of thousands of dollars—in some cases, as much \$500,000. Peer WDT (CO Trial Ex. 13) at 7; 2/5/08 Tr. at 1573-74 (Peer). Advances, in the aggregate, are a large and risky investment for publishers. Industry-wide, music publishers invest hundreds of millions of dollar in advances each year. *See Santisi WRT* (RIAA Trial Ex. 78) at 14-17; *see also supra* V.B.2. In 2005, for example, BMG MP advanced nearly \$30 million to new and previously-signed songwriters, representing more than 20% of the company's revenue that year. Firth WDT (CO Trial Ex. 24) at 10. EMI MP's advances averaged nearly [REDACTED] per year over the years 2003-2005. Faxon WDT (CO Trial Ex. 3) at 7. As Mr. Faxon explained, "The payment of these advances by publishers is essential to enabling both new and established songwriters to develop their talent and create new songs." *Id.* at 7.

782. Music publishers provide critical creative support to songwriters, as well. *See supra* V.B.3. Numerous publishers testified to the efforts that they make to help writers hone their craft, as well as the work they do to arrange collaborations with producers, recording artists and labels. *See id.* Songwriters affirmed the value of those contributions. *See id.* As Mr. Bogard explained, his relationships with publishers “have given me the opportunities to develop as a songwriter and helped me learn to write the best possible songs I can.” Bogard WDT (CO Trial Ex. 2) at 10. Even after songs are complete, publishers play a vital role in promoting their songwriters’ work. These efforts include, among other things, the creation of demo recordings (a costly undertaking) as well as the work that publishers perform identifying artists who can record their writers’ work. *See id.* The administrative work that publishers perform on behalf of songwriters—licensing and collecting royalties, among other tasks—is similarly essential, and the shouldering of those burdens allows songwriters to focus on their work. *See supra* V.B.5.

783. Contrary to the testimony of various RIAA witnesses, including Professor Teece, publishers’ promotional efforts—song-plugging as it is known in the trade—is not limited to Nashville. *See Teece WDT* (RIAA Trial Ex. 64) at 106-108. As Professor Teece conceded, he had never spoken to any publishers about the functions they perform outside of the country music genre and Nashville. 2/19/08 Tr. at 3761-63 (Teece). His claim that publishers’ contributions are limited to that city is wholly contradicted by the evidence from music publishers who have appeared in this proceeding—Mr. Faxon of EMI MP, Mr. Robinson of Famous Music, Mr. Peer of Peermusic and Mr. Firth of BMG—all of whom explained the substantial financial and creative investments they

make in the development and promotion of their songwriters. *See* Faxon WDT (CO Trial Ex. 3) at 4-12; Robinson WDT (CO Trial Ex. 8) at 10-21; Peer WDT (CO Trial Ex. 13) at 4-18; Firth WDT (CO Trial Ex. 24) 6-20.

784. Thus, the RIAA's suggestion that the Copyright Owners do not provide meaningful contributions to the production of music is flatly at odds with the evidence.

4. Income From Other Sources of Revenue Will Not Compensate Copyright Owners For A Reduction In Mechanical Royalties

785. The RIAA has asserted that the impact of any reduction in the statutory rate will be mitigated by the continuing increase in other sources of revenue, such as performance or synchronization royalty income. Professor Teece and Ms. Santisi were the principal sponsors of the argument. *See, e.g.*, Teece WDT (RIAA Trial Ex. 64) at 62; Santisi WRT (RIAA Trial Ex. 78) at 17-22.

786. As explained in the Copyright Owners' Proposed Conclusions of Law, a reasonable royalty under Section 801(b) does not depend upon non-mechanical sources of revenue. But putting the legal standard to one side, the evidence shows that a decline in the statutory rate will not be offset by other revenue streams.

787. Songwriters and music publishers alike have been experiencing a decline in mechanical revenues. *See supra* IV.C.1-2. The only systematic study of songwriters' income, performed by Professor Landes, shows that between 2000 and 2006, total songwriter income (inclusive of all royalty types) has at best held steady. Landes WRT (CO Trial Ex. 406) at 9-10. Indeed, in many of the intervening years, songwriter income was lower than it was in 2000. *Id.*

788. More importantly, Professor Landes's study demonstrates that many songwriters depend heavily on mechanical royalties. *See supra* IV.C.2. Of the

songwriters in Professor Landes's "songwriter subgroup," approximately 55 percent of songwriters received over half of their total royalty income from mechanicals, and 30 percent received three-quarters or more of their total income from mechanicals. Landes WRT (CO Trial Ex. 406) at 11. As a result, Professor Landes concludes that "a reduction in mechanical income would reduce further the earnings of a significant fraction of songwriters." Landes WRT (CO Trial Ex. 406) at 8. The RIAA has provided no evidence to the contrary.

5. The RIAA Has Not Shown That The Music Publishing And Songwriting Industries Are Less Risky Than The Recorded Music Industry

789. The RIAA has also attempted to justify its proposed reduction in the statutory rate on its claim that music publishing is less risky than the recorded music business. The claim has been advanced by several of the RIAA's experts. *See Teece WDT (RIAA Trial Ex. 64) at 63-69; Slottje WRT (RIAA Trial Ex. 81) at 10-16; Santisi WRT (RIAA Trial Ex. 78) at 7-33.* The weight of the evidence is to the contrary.

(a) Professor Teece's Measurement of Relative Risk is Flawed

790. Professor Teece purported to measure the relative risks in the music publishing and recorded music industries by comparing the profit margins of EMI Music with EMI MP over the fiscal years 1999 through 2006. He reported that the "coefficient of variation" in income, which is a measure of the volatility of a business's profits, was 21.9% for EMI Music and 3.7% for EMI MP. Teece WDT (RIAA Trial Ex. 64) at 68. Professor Teece argued that "this statistic demonstrates the low volatility and risk of music publishing relative to music recording." *Id.*

791. The evidence, however, indicates that whatever Professor Teece's analysis says about EMI, there is no basis in the record for extending the results to the rest of the music publishing and recorded music industries. Putting to one side that the EMI analysis was constructed on the basis of worldwide rather than U.S. numbers, *id.* at 68, it is clear that any analysis of EMI does not obtain for the rest of the industry. EMI's executives readily conceded that its recorded music company had performed poorly relative to the rest of the industry. Mr. Munns, the company's Vice Chairman, explained that when he took over, "the company was a mess" because of out of control spending. 2/26/08 Tr. at 4750 (Munns). He acknowledged that his predecessors had managed the business badly, with excessive spending on advances, artist signings and marketing. *Id.* Colin Finkelstein, the CFO of EMI Music North America, testified to a sharp decline in the company's U.S. market share and resulting negative impact on the company's profitability. 2/13/08 Tr. at 3157-58 (C. Finkelstein). He also testified that EMI Music's profitability had been affected by unusually high return rates on its physical product. *Id.* at 3174.

792. As a result, EMI Music's financial performance lagged the rest of the industry. *See* H. Murphy WDT (CO Trial Ex. 15) at 18. EMI Music's [REDACTED]. *Id.* at 18. That figure [REDACTED] in 2002 and 2003, when it reached [REDACTED]. *Id.* at 19. The company then saw a [REDACTED] in profitability in 2004 and 2005, when its margin was [REDACTED], and it saw [REDACTED] in 2006. *Id.* No other major record company was [REDACTED]. *See id.* at 18-19.

793. Professor Teece's analysis also ignored entirely the risks incurred by songwriters. The record shows that those risks are real and significant. When Professor

Landes applied the coefficient of variation to songwriters, he found that songwriting is far riskier than the recorded music business. Landes WRT (CO Trial Ex. 406) at 12-13. He concluded that the average coefficient of variation for individual songwriters was 91%, or more than four times EMI Music's corresponding measure of 21.9%. *Id.* at 13. Thus, "according to Professor Teece's own metric of risk, and in contrast to his conclusion that the Copyright Owners face less risk than do the record companies, songwriters face more than four times the risk that record companies do." *Id.*

(b) Ms. Santisi's Testimony About Relative Risk is Entitled to No Weight

794. Ms. Santisi, too, asserted that "any risks taken by music publishers are minimal compared to the risks taken by record labels." Santisi WRT (RIAA Trial Ex. 78) at 5. But her analysis suffers from the same infirmity as that of Professor Teece: she ignores the risks incurred by songwriters because she was instructed by the RIAA only to compare record companies with music publishers. 5/7/08 Tr. at 5207-08 (Santisi). As a result, she ignored the risks faced by songwriters notwithstanding her recognition that songwriters receive the lion's share of mechanical royalties and are principally affected by changes in the mechanical royalty rate. *See id.* at 5209-10.

(c) Professor Slottje's Testimony Concerning Relative Risk is Not Supported by Empirical Evidence

795. Professor Slottje asserted that record companies are not receiving an appropriate return based on the risks they incur. Slottje WRT (RIAA Trial Ex. 81) at 10-16. He testified to "enormous risky investments required by record companies," *id.* at 14, and argued that the mechanical royalty rate should account for those higher risks relative to those incurred by music publishers, *see id.* at 10-13. But Professor Slottje's conclusions are not supported by any empirical analysis of the relative risks incurred by

record companies, music publishers and songwriters. *See id.* at 10-16. In addition, he conceded that record companies have many ways to diversify risk, including hiring multiple recording artists, working with multiple songwriters, putting out multiple recordings (with the expectation that only some will succeed), getting involved in concert tours, and developing merchandising opportunities. 5/8/08 Tr. at 5408-09 (Slottje). And to the extent that record companies are part of large multimedia conglomerates, the risk of the recorded music business is tempered by being part of larger companies with diversified portfolios of business. *Id.* at 5410.

796. Finally, Professor Slottje’s claim that the statutory rate must take into account the risks faced by record companies misses one fundamental point: those companies have chosen to rely on an inherently risky business model. Many of the RIAA’s witness explained that record companies employ a “hit”-based model, in which the majority of their artists and recordings will not be profitable. *See, e.g.,* Teece WDT (RIAA Trial Ex. 64) at 21 (“It is widely recognized that most sound recordings are not profitable.”); 5/8/08 Tr. at 5342 (Slottje) (“the likelihood of any given particular song becoming a hit is low”); Kushner WDT (RIAA Trial Ex. 62) at 25 (“only one out of every ten new artists signed to major record labels will have a successful album”). Mr. Faxon explained that this riskiness is not inevitable: “the record business is inherent with [risk], but it doesn’t need to be more inherently risky to be in the record business.” 1/30/08 Tr. 573-74 (Faxon). The recorded music business is high-risk but also high-return, and “that’s the economics of the business.” *Id.* at 575-76. As Professor Landes explained, there is no economic justification for permitting the record companies to push

some of their risk onto music publishers and songwriters. Landes WRT (CO Trial Ex. 406) at 20-21.

797. In short, as with the claims advanced by Professor Teece and Ms. Santisi concerning the risks incurred by the parties to this proceeding, Professor Slottje's arguments are baseless.

6. The Copyright Owners' Have Made Significant Efforts To Fight Piracy

798. Piracy plagues the recorded music industry. The adverse effects are felt not only by record companies, but by songwriters and publishers alike. *See* Landes WDT (CO Trial Ex. 22) at 32-33. Mr. Israelite testified that piracy has "dramatically undercut the mechanical royalty stream." Israelite WDT (CO Trial Ex. 11) at 10; *see also* 1/31/08 Tr. at 938 (Robinson). And Mr. Faxon observed that his decline represents "lost opportunities for songwriters to have their songs put into the marketplace." 1/29/08 Tr. at 425 (Faxon).

799. In yet another argument to justify its proposed statutory rate, the RIAA asserts that the Copyright Owners have not contributed meaningfully in the fight against piracy. The RIAA's principal witness on this issue, Ms. Bassetti, claimed that publishers "have assumed only a small role in combating" piracy. Bassetti WDT (RIAA Trial Ex. 68). The evidence, however, is to the contrary.

800. Music publishers have been actively involved in high-profile piracy lawsuits. *Supra* II.A.1.c. Although Ms. Bassetti asserted that publishers had "typically assumed a secondary role" in anti-piracy litigation, Bassetti WDT (RIAA Trial Ex. 68) at 21, the record reveals that the NMPA, acting on behalf of the Copyright Owners, took a lead role in the critically important lawsuits against the Napster and Grokster services.

See also 2/19/08 Tr. at 3921-25 (Bassetti). There is also no dispute that publishers took a critical role in the promotion of legitimate online music outlets by entering into rateless deals with the RIAA and digital music services that facilitated the launch of lawful alternatives to the unlawful peer-to-peer music sites.

801. That the Copyright Owners joined the record companies in anti-piracy efforts should come as no surprise: As Ms. Bassetti acknowledged, every sale that is lost due to piracy is a sale lost to both the music publisher and songwriter. 2/19/08 Tr. at 3913-14 (Bassetti). The record shows that piracy has had severe and adverse effects on songwriters and music publishers. *See supra* IV.C. Mechanical royalties have dropped due to piracy, and as an obvious consequence acknowledged even by witnesses for the RIAA, songwriters' income has been negatively impacted. *See id.*

XVI. DiMA's Arguments Lack Merit

A. Overview

1. DiMA's Proposal Would Cut the Mechanical Royalty Rate Significantly

802. DiMA initially proposed a reduction in the mechanical royalty payable for the sale of a permanent download from 9.1 to 4 cents. In the Matter of Mechanical and Digital Phonorecord Delivery Rate Adjustment Proceeding, *Proposed Rates and Terms of DiMA*, Docket No. 2006-3 CRB DPRA (November 30, 2006), at 1-2 ("Initial DiMA Proposal"); *see also* 2/25/08 Tr. at 4284 (Cue). Specifically, DiMA proposed a mechanical royalty rate of 4.1% of a licensee's "applicable receipts," which were defined as "that portion of the money received by the licensee ... directly attributable to the digital phonorecord delivery." *Id.* DiMA did not propose a minimum fee, claiming that would somehow "pose substantial risks to the entry and expansion of firms," among other

problems. Guerin-Calvert WDT (DiMA Trial Ex. 7) at 9; 2/25 Tr. at 4450-51(Guerin-Calvert).

803. DiMA ostensibly based its initial proposal on economic and industry analysis performed by its expert economist, Margaret Guerin-Calvert. Ms. Guerin-Calvert opined that “a rate in the 4% to 6% of retail range, most appropriately at the lower end of that range, would better achieve the four [statutory] objectives.” Guerin-Calvert WDT (DiMA Trial Ex. 7) at 8.

804. On rebuttal, DiMA submitted a new and increased rate proposal for permanent downloads of 6% of applicable receipts. DiMA Amended Proposal 4. Abandoning its claim that minimum fees would retard the growth of the digital music industry, DiMA’s amended proposal includes a minimum fee for permanent downloads of 4.8 cents per track for single tracks or 3.3 cents per track for tracks sold as part of bundles. *Id.*

805. DiMA’s current proposal would still cut the mechanical royalty rate by at least one-third—a drastic and unjustified change that is unsupported by the weight of the evidence. Nor does the amended proposal guarantee that the Copyright Owners will be fairly compensated for the reproduction and distribution of their musical works because the amended revenue definition proposed by DiMA excludes certain key sources of revenue, such as some forms of advertising revenue. *Id.* at 1-3. These exclusions would permit digital music services to substantially manipulate the revenue base to which the 6% royalty rate would apply. Finally, DiMA’s proposed minimum fees are particularly pernicious, because they threaten to cut the mechanical royalty rate, if applied, by approximately 50-60%. *Id.* at 4.

2. DiMA Has Failed to Establish That a Rate Cut is Justified

806. DiMA has failed to provide any proof to support its consistent refrain throughout this proceeding that the infancy of the digital music market, the investments made by digital media companies to this point, and the risks they face going forward necessitate a cut in the mechanical royalty rate. *See generally* Guerin-Calvert WDT (DiMA Trial Ex. 7) at 4-9.

807. DiMA offered a series of “benchmarks” or, as Ms. Guerin-Calvert put it, “reference points,” during the direct phase of the proceeding. Although difficult to discern, the two principal benchmarks ultimately identified by Ms. Guerin-Calvert were the 1981 Decision by the Copyright Royalty Tribunal and the recent settlement agreement concerning mechanical and performance royalties in the U.K. (the “U.K. Settlement”). Guerin-Calvert WDT (DiMA Trial Ex. 7) at 13-14; 2/25/08 Tr. at 4478-81 (Guerin-Calvert). In addition, Ms. Guerin-Calvert cited a number of additional purported benchmarks, including the 1997 Agreement, the 2001 Agreement between the RIAA, NMPA and HFA concerning subscription services, and subsequent “interim agreements” reached as a result of and modeled after the 2001 agreement. Guerin-Calvert WDT (DiMA Trial Ex. 7) at 13-14. DiMA presented no additional benchmarks during the rebuttal phase.

808. As shown below, DiMA’s benchmark analysis is unmoored from any evidentiary support in the record, and not properly grounded in economic theory. Ms. Guerin-Calvert offers only a series of vague instructions to the Court in her attempt to connect them with DiMA’s rate proposal, claiming that the appropriate rate structure “must be sufficiently flexible to account for a variety of business models, uncertainties and financial risks;” “must take into account the high level of consumer price sensitivity

for digital music;” and “should take into consideration the elements considered in the 1980/81 decision but must also account for fundamental differences that may exist in industry conditions.” Guerin-Calvert WDT (DiMA Trial Ex. 7) at 6-7. These generalities offer no guidance for the determination of a reasonable royalty rate.

B. DiMA Has Provided no Appropriate Benchmarks

1. The 1981 CRT Decision Is Not an Appropriate Benchmark

809. In her written direct testimony, Ms. Guerin-Calvert “focused [her] primary review on the 1980/81 decision because it applied the same objectives involved in this proceeding.” Guerin-Calvert WDT (DiMA Trial Ex. 7) at 13. As set forth below, although Ms. Guerin-Calvert initially suggested that the 1981 Decision was a valid benchmark, she repudiated that view during the rebuttal case hearing.

810. The 1981 Decision is of limited utility today because, as the Copyright Owners and Copyright Users both agree, the U.S. music market has fundamentally changed since the CRT decision was issued in 1981. *See, e.g.*, Robinson WDT (CO Trial Ex. 8) at 7; 2/25/08 Tr. at 1632-34 (Peer); Teece WDT (RIAA Trial Ex. 64) at 109; Munns WDT (RIAA Trial Ex. 76) at 2. Ms. Guerin-Calvert herself acknowledged as much: “The dramatic shifts in physical units towards CDs . . . and the subsequent increase in digital distinguish the current period from the 1980/81 period, where there was a relatively static and mature industry with a known and accepted format for music.” Guerin-Calvert WDT (DiMA Trial Ex. 7) at 19, 15-23; 2/26/08 Tr. at 4557-58 (Guerin-Calvert). Indeed, Ms. Guerin-Calvert concluded that “the making and delivery of mechanical reproductions of ‘phonorecords’ today is fundamentally different from the industry in 1980/81.” Guerin-Calvert WDT (DiMA Trial Ex. 7) at 15.

811. In addition, Ms. Guerin-Calvert's use of the decision to derive a range of rates she considers reasonable is flawed. According to Ms. Guerin-Calvert the rate structure adopted by the CRT "would have generated approximately a 5% of retail revenue estimate at its implementation." *Id.* at 8, 59 n.80; 2/25/08 Tr. at 4480-81 (Guerin-Calvert). Ms. Guerin-Calvert claims to have reached that estimate, the only quantitative benchmark in her written reports, by following the same formula applied by Professor Teece. That is, she multiplied the penny rate (4 cents) set by the CRT in 1981 by the then-average number of tracks on an album (10), and then divided the product (\$0.40) by a 1981 album retail list price of \$7.98, which she assumed was the average actual retail price. Guerin-Calvert WDT (DiMA Trial Ex. 7) at 13; see also 2/26/08 Tr. at 4558-60 (Guerin-Calvert); Teece WDT (RIAA Trial Ex. 64) at 77 n.94; 2/19/08 Tr. at 3678-79 (Teece).

812. As described above, however, this calculation is wrong. It is based on the faulty assumption that \$7.98 could be used as the functional equivalent of the average actual retail price. In fact, when asked, Ms. Guerin-Calvert agreed that there were different retail and list price points in the market in 1980, and that budget and midline product, for example, were priced below \$7.98. 2/26/08 Tr. at 4560 (Guerin-Calvert).

813. Nor does the 1981 decision provide support for a percentage rate, as Ms. Guerin-Calvert contended. When asked whether the CRT applied a percentage rate, Ms. Guerin-Calvert conceded that the "rate methodology chosen [by the CRT] was a different rate methodology," resulting in a mechanical royalty rate of 4 cents per song. *Id.* at 4558. She also admitted that the 4-cent rate applied no matter how many songs were placed on an album. *Id.* at 4558-60 (Guerin-Calvert).

814. During her oral testimony, Ms. Guerin-Calvert first minimized the importance of the 1981 Decision and, then, during the rebuttal phase of the proceeding, rejected it as a benchmark for this proceeding. Ms. Guerin-Calvert testified that “with regard to benchmark on structures and methodologies that apply to a digital world, the world that was examined in 1981 is sufficiently different for all the reasons that we’ve talked about; that I would not say it’s a closely analogous benchmark in that regard.” 5/6/08 Tr. at 4865 (Guerin-Calvert). When asked specifically about the application in this proceeding of the 5% rate discussed in her Written Direct Testimony, Ms. Guerin-Calvert conceded that the Court should not rely on the rate set in the 1981 proceeding. *Id.* at 4866. This should end any attempt by DiMA to rely on the 1981 Decision as a benchmark.

2. The U.K. Rate Is Not an Appropriate Benchmark.

815. At the direct trial, Ms. Guerin-Calvert asserted, for the first time, that the U.K. Settlement, which was mentioned primarily in footnotes and an appendix to her Written Direct Testimony, “was the most relevant” benchmark for her rate recommendation. 2/25/08 Tr. at 4478 (Guerin-Calvert); *see* Guerin-Calvert WDT (DiMA Trial Ex. 7) at 10 n.7, 14 n.16, 55 n.76, Appendix on U.K. Agreements; 2/26/08 Tr. at 4537-47 (Guerin-Calvert) (admitting to minimal reliance on the U.K. Settlement in her Written Direct Testimony). Ms. Guerin-Calvert alleged that the U.K. Settlement was a better benchmark than others on the purported grounds that “it involves the same industry participants that are involved here,” and that “it was the most closely comparable with regard to it being . . . immediately pertinent to today’s digital music industry and to the participants here.” 2/25/08 Tr. at 4479 (Guerin-Calvert). The evidence is all to the contrary.

816. As described above in Section XV.B.4, reliance on rates from different countries is of limited, if any, usefulness. There are myriad differences between the U.S. market and foreign markets that neither Ms. Guerin-Calvert nor any other witness for DiMA or the RIAA took into account. The U.S. and U.K. mechanical royalty rate systems in particular differ in fundamental ways. Among others, there is no compulsory licensing scheme in the U.K., 5/15/08 Tr. at 6789 (Fabinyi), and the use of controlled composition clauses in the U.K. have been overridden by industry agreements. *Id.* at 6793-94.

817. Ms. Guerin-Calvert herself testified to the shortcomings of the U.K. Settlement as an appropriate benchmark. She conceded that “[w]hile these agreements and licensing arrangements are informative and provide insight into the nature of the terms and conditions that participants to a two-sided contract or settlement agreement can reach, I emphasize that each have some conditions or circumstances that are specific to the context or to the participants and were reached in a context different from the one before the Board which includes the fulfillment of the four specific objectives. *For example, agreements outside of the U.S. have different durations and a different package of property rights, among other differences.*” Guerin-Calvert WDT (DiMA Trial Ex. 7) at 10 n.7, emphasis added; *see also id.* at 14 n.16, Appendix on U.K. Agreements; 2/26/08 Tr. at 4545-56 (Guerin-Calvert). In endorsing the U.K. Settlement as her principal benchmark, Ms. Guerin-Calvert inexplicably failed to heed her own admonitions.

818. The U.K. Settlement provides for a royalty rate of 8%, not the 4% or 6% variously proposed by DiMA. *See* DiMA Trial Ex. 3, Ex. E at 39-41. Ms. Guerin-

Calvert could not explain how the 8% rate led her to conclude that no rate in excess of 6% could be reasonable, offering only the vague assertions that “[i]n looking at the U.K. rate, again, trying to abstract out the rights other than mechanical rights that gave me a range of somewhere in the 6 to 8 percent [range] for the U.K. rates.” 2/25/08 Tr. at 4481 (Guerin-Calvert). Such testimony provides no empirical basis whatsoever for converting the U.K. rate into a reasonable royalty for the U.S. statutory license.

819. Ms. Guerin-Calvert’s reliance on a U.K. benchmark also fails to consider the differences between the revenue base specified in the U.K. Settlement and the definition of revenue proposed by DiMA. When specifically asked to compare the U.K. revenue base with DiMA’s proposal for the U.S., Ms. Guerin-Calvert concluded that “[i]t’s not identical,” further proof that the U.K. rate is not a sound benchmark. 5/6/08 Tr. at 4874 (Guerin-Calvert).

820. Indeed, although the U.K. rate was supposed to be her “most relevant” benchmark, Ms. Guerin-Calvert lacked knowledge to testify credibly about the U.K. Settlement or the U.K. digital music market. During the direct hearing, Ms. Guerin-Calvert could not recall with any specificity whether she had studied anything relating to the U.K. rate other than an opinion issued by the U.K. Tribunal. 2/26/08 Tr. at 4548-50 (Guerin-Calvert). She admitted that she had done no independent empirical work to determine how the level of investment made in the U.S. digital market compared with that made in the U.K., or whether varying levels of investment had resulted in varying profit margins in the two countries. *Id.* at 4554-57. And during the rebuttal case hearing, Ms. Guerin-Calvert conceded that following the direct case hearing she left her initial work unfinished. 5/6/08 Tr. at 4872-73 (Guerin-Calvert). She did not perform any

additional economic analysis on the similarities or differences between the two markets and, during the rebuttal trial, could not even recall how the size of the U.K. digital music market compared to the market in the U.S. *Id.*

3. DiMA's Alternative Agreements Are Not Appropriate Benchmarks

821. Ms. Guerin-Calvert's additional benchmarks—the 1997 Agreement, the 2001 Agreement and a series of interim agreements for subscription service—fare no better.

822. Ms. Guerin-Calvert offered the rate set by the 1997 Agreement, a settlement admittedly “reached outside the application of the 801(b)(1) objectives,” as a benchmark based on analysis similar to her analysis of the 1981 Decision. Guerin-Calvert WDT (DiMA Trial Ex. 7) at 14 n.12.

823. According to Ms. Guerin-Calvert, when the penny rate contained in the 1997 Agreement is converted into a percentage of revenue, “[t]he 1997 rate was approximately 5.3% of the retail price, slightly above the rate set in the 1981 CRT decision.” *Id.* Ms. Guerin-Calvert testified that she calculated that percentage by using information about average CD retail prices and “assumptions with regard to the number of tracks on a CD.” 2/26/08 Tr. at 4562 (Guerin-Calvert).

824. Ms. Guerin-Calvert's own evidence, however, shows that she performed her calculations incorrectly. According to the graph charting the “Percent of CD Retail Price Accounted for by Mechanical Royalties Over Time” contained in the general appendix to Ms. Guerin-Calvert's Written Direct Testimony, the actual percentage of CD retail price that went to mechanical royalties in 1997 was between 7% and 7.5%, not 5.3%. 2/26/08 Tr. at 4564 (Guerin-Calvert); Guerin-Calvert WDT (DiMA Trial Ex. 7)

Ex. A at 34. Ms. Guerin-Calvert could find no other calculation contained in her written report to support her contentions. 2/26/08 Tr. at 4566 (Guerin-Calvert). Nor could she provide an alternative explanation that supported her estimate of 5.3%. *Id.* In the circumstances, her claim that the 1997 Agreement supports DiMA's proposed rates is entitled to no weight.

825. Apart from her error, Ms. Guerin-Calvert offered no basis on which to link the 1997 Agreement to DiMA's proposal. All she could say was that she chose to "take it into consideration, to look at the nature of the agreement and then say, applying the statutory objectives, which were not applied in that agreement, how would one want to either move up or move down the rates, and also consider the rate methodology as to the best recommendation." 2/26/08 Tr. at 4567 (Guerin-Calvert).

826. Ms. Guerin-Calvert also presented the 2001 Agreement and a series of "interim agreements" that followed it as other possible benchmarks. *See* Guerin-Calvert WDT (DiMA Trial Ex. 7) at 13-14, 58. These agreements, as discussed in Section II.C.5 advanced the development of the legitimate digital music market, as other witnesses have testified. *See, e.g.*, 2/5/08 Tr. at 1403-07 (Robinson); 2/25/08 Tr. at 4383 (McGlade). They do nothing, however, to advance the determination of an appropriate mechanical royalty rate in this proceeding.

827. As Ms. Guerin-Calvert admitted repeatedly, these agreements did not contain a specific mechanical royalty rate and were designed to require retroactive payments pending the outcome of the current proceeding. Guerin-Calvert WDT (DiMA Trial Ex. 7) at 14 n. 13; 2/26/08 Tr. at 4536-37 (Guerin-Calvert). Simply put, these

agreements “had an open part that would defer to the outcome for this particular proceeding as to what the actual rate would be.” *Id.* at 4531.

828. Ms. Guerin-Calvert’s explanation for how the rateless interim agreements supported DiMA’s proposed rates was as vague as her testimony about the 1997 Agreement. According to Ms. Guerin-Calvert, these rateless deals “provide an understanding of the kinds of arrangement that the industry is attempting to make to specify some amounts of monies for the right to access the copyrights. The way in which it was also relevant ... is the fact that they were not able, in these agreements, to actually specify a rate at that point that everyone could agree to that would work for the industry for the particular rights, but nonetheless agreed to amounts of money or advances so that the industry could move forward. So I regarded it as relevant and informative to my analysis that there was not a rate that was specified.” *Id.* at 4534-36. Ms. Guerin-Calvert’s attempts to explain the relevance of these agreements make little sense. If, contrary to common sense, there is a way to use a rateless agreement pegged to the outcome of this proceeding as a benchmark against which the rate in this proceeding can be set, Ms. Guerin-Calvert did not provide it .

829. Ms. Guerin-Calvert similarly failed to provide an empirical basis for support of DiMA’s proposed minimum rates. All that she offered was her admonition that minimum fees “should be implemented or chosen only with great caution” because “they impose potential risks in terms of inadvertently imposing costs for participants in the industry.” 5/6/08 Tr. at 4807-08 (Guerin-Calvert) In the end, she offered nothing to dispel the notion that the 4.8 cent rate for singles and 3.3 cent rate for tracks sold as bundles had “no basis in agreements or [were] wholly unsupported by anything other

than this was what DiMA members thought was fair,” as Judge Roberts observed. 5/6/08 Tr. at 4908 (Roberts, J.).

C. DiMA’s Other Arguments Fail to Support Its Proposed Rate Reduction

830. DiMA has also claimed that a reduction in the mechanical royalty rate is required because the digital music industry is nascent and costs must be kept low to encourage new entrants. In addition, according to DiMA, a reduction in the royalty rate better responds to the downward price pressures and price sensitivity that characterize the digital market. DiMA has also implied that without such a reduction, digital music providers will be unable to grow or succeed. *See generally* Guerin-Calvert WDT (DiMA Trial Ex. 7) at 48-53; Cue WDT (DiMA Trial Ex. 3) at 3, 26-31, 37-38; Quirk WDT (DiMA Trial Ex. 8) at 3-4, 24-25, 31. These arguments are not supported by the weight of the evidence which shows, conclusively, that the permanent download market has developed and thrived at the current mechanical rate and will continue to do so in the view of every industry analyst.

1. The Permanent Download Market is Not Nascent

831. Ms. Guerin-Calvert and other DiMA witnesses repeatedly testified that “[d]igital music consumption is nascent.” Guerin-Calvert WDT (DiMA Trial Ex. 7) at 24; *see also id.* at 3-6, 53; 2/25/08 Tr. at 465 (Guerin-Calvert); Cue WDT (DiMA Trial Ex. 3) at 3; 2/25/08 Tr. at 4264-65 (Cue). Although it is true that both the U.S. digital music industry generally and the permanent download market in particular are continuing to develop and evolve, *see* Enders WDT (CO Trial Ex. 10) at 18, it is not true that the permanent download market is only “in its initial stages of development.” Guerin-Calvert WDT (DiMA Trial Ex. 7) at 3, 53.

832. Apple's iTunes Store launched in April 2003, over five years ago. As described above, it was an immediate success. *See* 2/25/08 Tr. at 4246, 4236 (Cue). Largely due to this success, the permanent download market is now well-established, popular and profitable. *See* Enders WDT (CO Trial Ex. 10) at 27-32; *see also* Section 7.D. Ms. Guerin-Calvert herself tracked this growth in her direct testimony, illustrating how sales of digital singles grew from 139.4 million in 2004 to 366.9 million in 2005, and sales of digital albums grew from 4.5 million to 13.6 million during the same period. Guerin-Calvert WDT (DiMA Trial Ex. 7) at 17. This growth continued into 2006, in which roughly 11.0 million single track permanent downloads and 592,000 digital album permanent downloads were sold, on average, each week. Enders WDT (CO Trial Ex. 10) at 23. In total, revenues for the permanent download market reached \$878 million in 2006, accounting for about 81% of the U.S. digital music market overall. Enders WDT (CO Trial Ex. 10) at 23. The iTunes Store alone generated approximately ██████████ in revenues in 2007. 2/25/08 Tr. at 4294-95 (Cue). Revenues are forecasted to grow to approximately \$2.7 billion by 2012. Enders WDT (CO Trial Ex. 10) 23 n.46, Ex. C at 4. These statistics are signs not of a nascent market but of a well-established and growing market. Not a shred of evidence supports the notion that a conversion to a percentage rate or a reduction in mechanical royalties is required to continue this growth.

2. A Rate Cut is not Required to Protect Companies in the Permanent Download Market or Encourage New Entrants

833. Ms. Guerin-Calvert also emphasized that many digital music services have already failed and suggested that “[t]he volatility of this industry, particularly decisions to exit the marketplace and the reasons cited for these decisions, are relevant to the issues before the CRB.” Guerin-Calvert WDT (DiMA Trial Ex. 7) at 29. To the extent there

has been exit from the digital market, it has not been with respect to services that sell permanent downloads.

834. The iTunes Store currently controls approximately 85% of the permanent download market. Enders WDT (CO Trial Ex. 10) at 28; 2/4/08 Tr. at 1178-80 (Enders). Not only did Apple achieve this market position under the current penny rate structure, it has done so notwithstanding two increases in the royalty rate (2004 and 2006) since the iTunes Store launched. 2/25/08 Tr. at 4277-78 (Cue). Although Eddy Cue, the Vice President of iTunes and DiMA's primary witness on the permanent download market, claimed in his written testimony that "this industry needs reduced, not increased, costs in order to continue to attract the investments necessary to its growth and stability," Cue WDT (DiMA Trial Ex. 3) at 39, he conceded that Apple does not need a rate reduction to continue to sell permanent downloads, or sell them profitably. In fact, Mr. Cue testified that penny rates 30% higher than DiMA's current proposal had not prevented the iTunes Store from growing into an extremely profitable business. Most importantly for assessing the unreasonableness of the rate proposed by DiMA (and the reasonableness of the Copyright Owners' proposal), Mr. Cue acknowledged that the mechanical royalty rate would have to be substantially *higher* than 15 cents per track before Apple would exit the digital music business. 2/25/08 Tr. at 4296, 4310-12 (Cue).

835. Moreover, the number of digital music providers selling permanent downloads is growing under the current mechanical royalty rate. Enders WDT (CO Trial Ex. 10) at 26-27. Traditional subscription services such as Rhapsody and Napster now offer permanent downloads, which generate a substantial portion of their annual revenues. *See id.* at 36-40. Wal-Mart and Amazon, among other retailers, have also

recently begun to offer permanent downloads. 2/4/08 Tr. at 1178-79 (Enders).

Furthermore, these new market entrants are selling permanent downloads at prices lower than Apple's standard prices, often at 89 cents per track.. 2/26/08 Tr. at 4570-71

(Guerin-Calvert); Guerin-Calvert WRT (DiMA Trial Ex. 10) at 10; *see also* Enders WDT (CO Trial Ex. 10) at 33; 2/4/08 Tr. at 1191-92 (Enders). All of this empirical evidence is at odds with DiMA's proposal to reduce mechanical royalties for permanent downloads.

3. DiMA Has Not Shown that the Permanent Download Market is Sensitive to Price

836. Ms. Guerin-Calvert's assertion that a cut in the mechanical royalty rate is required by the substantial price sensitivity in the digital music market is wrong. She states that "consumer pricing reflects the fact that many products and services are largely still in their introductory phases and the largest music catalog is otherwise available for free on pirate websites." Guerin-Calvert WDT (DiMA Trial Ex. 7) at 6; *see also id.* at 5, 51; 2/26/08 Tr. at 4581-84 (Guerin-Calvert). The argument is advanced without any empirical or economic support.

837. Ms. Guerin-Calvert fails to provide any empirical support for her price sensitivity theory. As a threshold matter, she did not perform her own price sensitivity or demand elasticity analyses on the permanent download market as a whole. 2/26/08 Tr. at 4583-84 (Guerin-Calvert). Nor did she perform any such study with respect to Apple, the dominant player in the permanent download market that was largely responsible for establishing 99 cents as the typical permanent download price. Ms. Guerin-Calvert conceded that she had never seen any price study commissioned by Apple. *Id.* at 4582. For good reason: no such study exists. 2/25/08 Tr. at 4332-35 (Cue).

4. A Rate Cut Is Not Required for the Permanent Download Providers to Grow or Succeed

838. As Mr. Cue admitted, [REDACTED] [REDACTED]. 2/25/08 Tr. at 4296 (Cue). That testimony undermines the repeated and unsupported claim by DiMA that a reduction in the royalty rate is necessary for the digital market to succeed.

839. Ms. Guerin-Calvert claims that the early successes achieved in the digital market have “not necessarily been accompanied by profitability and financial stability for the purveyors of digital music.” Guerin-Calvert WDT (DiMA Trial Ex. 7) at 5. With respect to permanent downloads, these conclusions are unsupported and do not justify a reduction in the mechanical royalty rate. The iTunes Store, for example, is already very profitable. [REDACTED]

[REDACTED]. 2/25/08 Tr. at 4292-93 (Cue); CO Trial Ex. 85. In fact, as discussed in detail above, the iTunes Store operates with profit margins “in the teens.” 2/25/08 Tr. at 4270 (Cue). In 2007, Apple’s profits from permanent download sales through the iTunes Store in 2007 were approximately [REDACTED], *id.* at 4295, and internal forecasts are predicting profits of [REDACTED] in fiscal year 2008. *Id.* at 4298; *see also* CO Trial Ex. 86. When asked specifically whether the iTunes Store needed a 50% rate cut in order to succeed in the online music business, Mr. Cue answered that it did not. *Id.* at 4284.

840. Neither DiMA’s proposed benchmarks nor its alternative arguments provide evidentiary support sufficient to justify a drastic reduction in the mechanical royalty rate for permanent downloads. Ms. Guerin-Calvert’s vague testimony offers the

Court no real or reliable guidance for the determination of a reasonable royalty rate for the now-thriving permanent download market. Without more, DiMA's proposal does appear to be based entirely nothing more than what DiMA members considered to be a fair royalty rate for them.

XI. The Parties' Proposed Terms

841. In addition to submitting written and oral testimony, exhibits, and rate proposals, the parties have also submitted proposals for additions and modifications to the terms of Section 115.

The Copyright Owners' Proposed Terms Are Supported by Record Evidence

842. Copyright Owners have proposed the following terms:

- **Late Fee of 1.5%:** Without affecting any right to terminate a license for failure to report or pay royalties as provided in § 115(c)(6), late fees shall be assessed at 1.5% per month (or the highest lawful rate, whichever is lower) from the date payment should have been made (the twentieth (20th) day of the calendar month following the month of distribution) to the date payment is actually received by the Copyright Owner.
- **Pass-Through Licensing Assessment of 3%:** For pass-through arrangements, there shall be an automatic 3% assessment on all royalty payments by the licensee to address the fact that the Copyright Owners would receive payment sooner if the retailer were paying the Copyright Owners directly (such assessment to be augmented by additional late fees at 1.5% per month if payment by the licensee is otherwise late).
- **Reasonable attorneys' fees expended to collect past due royalties and late fees:** A Copyright Owner shall be entitled to recover from the licensee reasonable attorneys' fees expended to collect past due royalties and late fees.
- **Applicability of Rates:** The statutory rate to be applied is the rate in effect as of the date of distribution.
- **Specific Licensing and Reporting:** Licenses are to be taken by specific configuration (*e.g.*, CD, cassette, permanent download, etc.). In addition to any other applicable requirements, reporting

must be broken down by specific configuration (*i.e.*, must detail how many units distributed of a particular configuration, and the applicable rate and royalties due for that configuration) and, in the case of pass-through arrangements, must be further broken down to indicate the retail outlet through which the distribution was made to the end user.

- **Revenue:** Revenue should be defined to include all monies and any other consideration paid or payable to, or received, earned, accrued or derived by, a User by or from any party in connection with a Licensed Service or a Licensed Product, including the fair market value of non-cash or in-kind consideration. (*See* Copyright Owners' Amended Proposal for examples and complete definition of proposed revenue terms.)

Copyright Owners' Amended Proposal at 2-4.

843. As described below, record companies frequently fail to make complete and timely royalty payments to Copyright Owners. The results of Harry Fox Agency's audits show the record companies' consistent failures to make payments when due and failures to pay the amounts actually owed, resulting in the substantial underpayment of royalties and the lost time value of money to the Copyright Owners. Pedecine WRT (CO Trial Ex. 394) at 4. Adoption of the Copyright Owners' proposed terms would provide incentives to the record companies to pay for the musical works they use in a timely and accurate fashion and compensate the Copyright Owners if record companies continue their noncompliance.

5. Late Payment Fees Would Encourage Timely and Complete Payment

844. Throughout the proceeding, witnesses for the RIAA acknowledged that the record labels frequently make incomplete and late royalty payments to Copyright Owners. *See* 2/14/08 Tr. at 3258 (C. Finkelstein) ("in the past we have agreed to make some payments, some late payments"); 5/12/08 Tr. at 5692 (A. Finkelstein) (agreeing that Sony BMG makes late payments). These delays—and the fact that the record labels

often pay significantly less than they actually owe—often are uncovered only through expensive audits long after the fact. Pedecine WRT (CO Trial Ex. 394) at 2. There is no mechanism in the current regulations to compensate Copyright Owners for the loss of use of their money and nothing that serves effectively to induce the record labels to make timely payment. As NMPA President and CEO David Israelite testified, “a late penalty in the 115 regulation might help that process because of the incentive it would give to users of our license to pay promptly.” 2/5/08 Tr. at 1431 (Israelite).¹⁴

(a) Record Companies Frequently Pay Late

845. An analysis of cash receipt data for mechanical royalties received by HFA from January 1, 2000 to September 5, 2007 confirms the magnitude of the labels’ late payment problem. Pedecine WRT (CO Trial Ex. 394) at 4-5. The analysis revealed that over 41,000 receipts totaling more than \$2.1 billion were received by HFA after their due date. *Id.* at 5. The receipts in question were, on average, 80 days late and represented over 70% of the mechanical royalties received by HFA during that time period. *Id.* So substantial were the delays and the monies withheld that, applying the Copyright Owners’ proposed 1.5% late fee, HFA would have received \$16 million in late fees for these overdue payments. 5/19/08 Tr. at 7034-36 (Pedecine).

¹⁴ Late fees of 1.5% were adopted by the CRJs in two prior proceedings. The CRJs held that such a late fee “strikes the proper balance” between “providing an effective incentive to the licensee to make payments timely” and “not making the fee so high that it is punitive.” *See* In re Determination of Rates and Terms for Preexisting Subscription Servs. and Satellite Digital Audio Radio Servs., Final Determination of Rates and Terms, 73 Fed. Reg. 4080, 4099 (January 24, 2008); In re Digital Performance Right in Sound Recordings and Ephemeral Recordings, Final Determination of Rates and Terms, 72 Fed. Reg. 24084, 24107 (May 1, 2007).

(b) HFA Has Recovered Hundreds of Millions Through Audits

846. The labels' late payment practices are also confirmed by the results of HFA's Royalty Compliance Examinations ("RCEs"). HFA regularly conducts RCEs, or audits, of licensees in order to evaluate their compliance with the terms and conditions of mechanical licenses issued by HFA and to assess whether licensees are paying royalties in full. Pedecine WRT (CO Trial Ex. 394) at 3. Alfred Pedecine, Senior Vice President and Chief Financial Officer of HFA, testified that HFA's RCEs recovered \$430 million in additional royalty payments from 1990 to 2007. Pedecine WRT (CO Trial Ex. 394) Ex. A. This amount represents approximately 6.2% of HFA's total receipts from licensees for that period. *Id.* at 6. NMPA President and CEO David Israelite testified: "It's millions upon millions of dollars that we collect through our process and [we are] probably not finding close to everything that we're owed. It's almost as if you had a tax system where there were no penalties if you didn't file your taxes." 2/5/08 Tr. at 1431-32 (Israelite). Every RCE that HFA has ever conducted has identified underpayments or failures to pay. *Id.* at 1429.

847. HFA's audits typically identify a number of deficiencies in licensees' royalty reporting and payment, including deficiencies in accounting, inventory and recordkeeping processes and procedures. Pedecine WRT (CO Trial Ex. 394) at 9. In some circumstances, the deficiencies appear to be the result of carelessness, but in other situations, the licensees appear to have willfully neglected to live up to the requirements imposed by the mechanical licenses that they have obtained from HFA or their obligations under the Copyright Act. *Id.* For example, record companies sometimes simply use the Copyright Owners' works without obtaining licenses through HFA or

directly from the relevant publisher. *Id.* In other instances, they obtain licenses, but underreport their use of the licensed compositions. *Id.* In other situations, record companies distribute significant numbers of “promotional” copies of recordings for which they do not pay royalties, even though these units are not exempt from royalty payments under either the relevant mechanical license or the Copyright Act. *Id.* Another common occurrence is the maintenance of excessive reserves in violation of the regulations found in 37 C.F.R. § 201.19. *Id.* In addition, audits have uncovered some licensees with unaccounted-for production, which means that the licensee’s records show that the units were manufactured and distributed, but no royalties were reported, paid or accrued. *Id.*

(c) The Record Companies’ Own Contracts Contain 1.5% Late Fee Provisions

848. Although the RIAA complains that the 1.5% fee proposed by the Copyright Owners is a “high fee” for late payments, A. Finkelstein WRT (RIAA Trial Ex. 84) at 8, all four of the major record labels receive late fees of at least 1.5% per month in their own contracts with digital music services. These include

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

849. They also include [REDACTED]

[REDACTED]

850. The Copyright Owners are seeking only the same compensation for delayed payment that all the major record companies receive from the digital music services. Colin Finkelstein, Chief Financial Officer of EMI Music, testified that he could offer no commercial reason why the publishers should not be entitled to the same benefit of a late payment that record companies obtain in their contracts. 2/14/08 Tr. at 3257-58 (C. Finkelstein).

(d) HFA's Right to Terminate is Not a Sufficient Enforcement Mechanism

851. The RIAA has taken the position that no late fee is necessary because the Copyright Owners already have a remedy: they can terminate a license for nonpayment. A. Finkelstein WRT (RIAA Trial Ex. 84) at 10. While it is true that Section 115 allows Copyright Owners to terminate a license in the event a licensee fails to pay, it is false to say this is an adequate remedy.

852. Terminating a license is a drastic step. It is administratively burdensome, costly and disruptive. Termination of a licensee is “a pretty severe process” that can be damaging to long-term business relationships. Pedecine WRT (CO Trial Ex. 394) at 10; 5/19/08 Tr. at 7041 (Pedecine). It “puts a hiatus on commerce for a while as it relates to that licensee.” *Id.*

853. Terminating a license is also an inadequate remedy because Section 115(c)(6) requires a 30-day notice period during which the licensee may cure. *See* 17 U.S.C. §115(c)(6); 5/19/08 Tr. at 7049 (Pedecine). Therefore, a licensee can withhold payment, cause HFA to initiate the disruptive and burdensome termination process, and then pay before the 30th day, all without suffering consequences or compensating Copyright Owners for the lost time value of the money. *Id.* *See* 5/12/08 Tr. at 5698 (A. Finkelstein) (agreeing that “if Sony BMG cures its late payment on Day 29, under the current statutory provisions, the Copyright Owner have no remedy for Sony BMG’s late payment up until that date”).

854. As Mr. Israelite testified, “there should be something in between doing nothing and having to terminate a license.” 2/5/08 Tr. at 1468 (Israelite). A late fee that

penalizes the record labels for their delays in payment and compensates the Copyright Owners is that something in between.

855. And it is something the record labels themselves employ although they too have the right to terminate licenses for nonpayment. [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

(e) Record Company Advances Do Not Cover Late Payments

856. Advances are paid by record companies to cover the time between the release of product and the resolution of copyright ownership interests in musical works or “splits.” They are not paid to compensate for late payments. 5/19/08 Tr. at 7071-75 (Pedecine).

857. Andrea Finkelstein inaccurately stated that record companies pay advances to cover late payments “occasioned by protracted negotiations among writers and publishers.” A. Finkelstein WRT (RIAA Trial Ex. 84) at 9. In her live rebuttal testimony, Ms. Finkelstein conceded that the Copyright Owners’ proposed late fee term would not be applied to unlicensed work. 5/12/08 Tr. at 5687 (A. Finkelstein). The late fee provision would only apply once split copyright shares have been determined and the

work is fully licensed. *Id.* at 5685-87. Therefore, as Mr. Pedecine explained, advances paid by the record companies are for unlicensed product, not for late payments once a product has been licensed and due for payment. 5/19/08 Tr. at 7071-72, 75 (Pedecine) (agreeing that “the role that advances serve is to pay for licenses not yet obtained”).

(f) HFA Cannot Simply Add a Late Payment Fee to Its Licenses

858. The Harry Fox Agency considers its mechanical license a “variant” or “derivative” of the Section 115 compulsory license. 5/19/08 Tr. at 7061 (Pedecine); 2/5/08 Tr. at 1298 (Israelite). HFA’s license contains a small number of payment and reporting terms that are more flexible than the Section 115 compulsory license, however, for the most part, HFA’s license “tr[ies] to stay very close to reflecting the terms of 115.” 5/19/08 Tr. at 7061-62 (Pedecine). According to Mr. Israelite, the HFA license is intended to “track” the 115 license “with the exception of a few places where we try to go under the requirement and make it easier.” 2/5/08 Tr. at 1466 (Israelite). Examples of HFA license’s variation from the compulsory license include a quarterly payment and accounting requirement instead of Section 115(c)(5)’s monthly payment and accounting requirement, *id.* at 1399; elimination of the need to find the publisher or pay a Copyright Office fee, *id.* at 1399-1400; assurance that the HFA license covers server copies, *id.* at 1399; and elimination of the statute’s notification requirement, 2/14/08 Tr. at 3327 (A. Finkelstein). *See also* RIAA Trial Ex. 29 (standard HFA DPD licensing agreement).

859. HFA’s modifications make it easier for copyright users to obtain licenses for musical compositions and as a result, “there is not much resistance to those terms that are different, that are more flexible.” 5/19/08 Tr. at 7055 (Pedecine). If, however, HFA seeks to impose more stringent requirements on licensees, such as when HFA seeks

interest on the late payments revealed in the RCEs, “there is usually a fair amount of resistance” and “sometimes licensees will say there is no provision for it under 115.” *Id.* at 7057.

860. Mr. Pedecine testified that in his experience, “if the late fee is not incorporated in the statutory—the compulsory license, it would be far more difficult to put it into our license and make it fully enforceable.” *Id.* at 7056. Mr. Israelite concurred: “If there were a late fee in 115, there would be a late fee in the Fox license.” 2/5/08 Tr. at 1466 (Israelite).

6. A Pass-Through Assessment Would Compensate Copyright Owners for Further Delay

861. Section 115(c)(3)(A) permits a compulsory licensee to authorize the distribution of a musical work by means of a digital transmission. In today’s digital music industry, record companies often use this authority to obtain mechanical licenses from HFA for musical works; they then “pass-through” to digital music services such as Apple or RealNetworks a mechanical license to distribute the musical works. 5/19/08 Tr. at 7050 (Pedecine). The record companies pay the mechanical royalties to HFA based on the reporting information provided by the digital music services. There are several consequences of this indirect relationship that has formed between HFA and the digital music services.

862. As Mr. Israelite testified, “[t]he existence of pass-through licenses imposes three distinct harms on music publishers and songwriters. First, pass-through licenses result in the inability of music publishers to audit the exact users of their rights—as is the case with Apple. Second, pass-through licenses result in payment delays. Third,

pass-through licenses prevent music publishers from establishing direct business relationships with digital media companies.” 2/5/08 Tr. at 1469-1471 (Israelite).

863. The prevalence of pass-through arrangements for the licensing of digital downloads impairs the ability of HFA and the Copyright Owners to perform complete and thorough audits because it precludes access to source transactions. Pedecine WRT (CO Trial Ex. 394) at 12. In the case of pass-through licenses, the direct licensee (usually a record label) does not have the source information that the pass-through licensee used to report and pay royalties to the record label. *Id.* at 13. Without access to the distributor’s books, records, server logs, and underlying source documents, HFA cannot audit the distributors and potentially uncover unpaid royalties in the same way that HFA does for labels. 5/19/08 Tr. at 7053-54 (Pedecine). HFA’s history of uncovering large amounts of unpaid royalties in its RCE process suggests that there is “a significant amount of money left to be found” and there is “no reason to believe that that wouldn’t be true in dealing with the services, but we can’t go that extra yard.” *Id.* at 7054. *See also* Faxon WDT (CO Trial Ex. 3) at 40-42 (detailing EMI MP’s pass-through licensing problems); CO Trial Ex. 3, CO 225 and CO 226.

864. In addition to increased auditing problems, pass-through arrangements also cause delays in royalty payments. Pedecine WRT (CO Trial Ex. 394) at 13. Licenses issued during the last month of a quarter are generally delayed by three months. 5/19/08 Tr. at 7050-52 (Pedecine). This delay occurs because record companies treat the pass-through units as being distributed in the month when the digital service reports to them, not when the transmissions actually take place. *Id.* Given the time value of

money, this delay in payment constitute a hidden discount to record companies. Faxon WDT (CO Trial Ex. 3) at 41; 2/5/08 Tr. at 1470 (Israelite).

865. The Copyright Owners' proposed 3% pass-through assessment would compensate Copyright Owners for the inability to directly audit the distributor's records and the additional delay of royalty payment which occur when a licensee authorizes another entity to distribute works on the licensee's behalf. 5/19/08 Tr. at 7050-54 (Pedecine); Pedecine WRT (CO Trial Ex. 394) at 12-13. *See also* 5/12/08 Tr. at 5655 (A. Finkelstein); Faxon WDT (CO Trial Ex. 3) at 41.

7. Reasonable Attorneys' Fees Would Compensate Copyright Owners for Efforts to Collect Past Due Royalties and Late Fees

866. In order to fully compensate the Copyright Owners for the labels' chronically late royalty payments and provide an additional incentive for licensees to pay in a timely manner, the Copyright Owners seek reasonable attorneys' fees for their efforts to collect past due royalties and late fees. Israelite WDT (CO Trial Ex. 11) at 15. Andrea Finkelstein argues that payment of attorneys' fees is already addressed in Section 505 of the Copyright Act. A. Finkelstein WRT (RIAA Trial Ex. 84) at 12. But that provision merely states that a court may award a reasonable attorney's fee to the prevailing party in a civil copyright infringement action. 17 U.S.C. § 115. That requires termination of the license. The purpose of the Copyright Owners' proposal is to avoid the need to adopt that drastic remedy to obtain just compensation. Therefore, Section 505 does not provide a suitable remedy to Copyright Owners who need legal assistance to collect past due royalties and late fees, but do not wish to take the radical step of terminating a license.

8. Clarification of the Applicability of Rates Would Further Prevent Incomplete Royalty Payments

867. The Copyright Owners also request a recordkeeping clarification from the CRJs that the date on which the mechanical license fee is calculated is the date of distribution, not the date of manufacture. Under Section 115(c)(2), the statutory royalty is payable for every phonorecord “made and distributed.” 17 U.S.C. § 115(c)(2). Currently, with respect to physical product, record companies use the date of manufacture as the date on which they calculate the royalty rate, even if they do not distribute the product until some later date. *Israelite WDT* (CO Trial Ex. 11) at 15-16. The record companies ignore the “made and distributed” requirement and instead stockpile product for distribution at a later time, when the applicable statutory fee is higher, and pay the lower fee in effect on the date of manufacture. *Id.* The Copyright Owners’ proposed term would end this practice and confirm that the date of distribution must determine the applicable royalty rate. Adoption of the proposed term would conform to the regulation for digital products, which provides that the date of digital transmission is the relevant date for determining the applicable royalty rate. 37 C.F.R. § 201.19(a)(6).

9. Specific Licensing and Reporting Would Facilitate Audits

868. As described above, HFA engages in periodic audits that uncover significant amounts of unpaid royalties. The accuracy of these audits depends on HFA’s access to detailed information about the licenses that are issued. *5/19/08 Tr.* at 7053 (*Pedecine*); *Pedecine WRT* (CO Trial Ex. 394) at 12-13. The Copyright Owners therefore seek a modification of the existing recordkeeping regulations to require licensing and reporting of the royalties earned for each specific configuration and, in the case of pass-through arrangements, that licensees identify the online retailer through

which digital deliveries occurred. Israelite WDT (CO Trial Ex. 11) at 16. During her live rebuttal testimony, Andrea Finkelstein acknowledged that Sony BMG currently reports this level of detail to HFA. 5/12/08 Tr. at 5706-06 (A. Finkelstein). The Copyright Owners simply seek to ensure that all licensees license and report in this manner, and to prevent the “uphill battle” that HFA sometimes encounters when licensees resist such requirements. 5/19/08 Tr. at 7105 (Pedecine). “Were the reporting provisions required . . . I would expect [that they would be] far more likely to be taken into consideration and/or complied with by the licensees.” *Id.*

869. Under the existing regulations (see 37 C.F.R. §§ 201.18(d)(1)(v)(D), 201.19(e)(3), (f)(4)), notices and royalty reports have to provide certain information concerning the configurations in which the licensee is distributing music, but such regulations lack a requirement that licensees distinguish among permanent downloads, limited downloads and interactive streams (or any other digital format) in taking licenses or reporting under licenses. The Copyright Owners’ proposed recordkeeping requirement would ensure that Copyright Owners are able to conduct more accurate audits with additional and critical pieces of information about what products are being licensed. Israelite WDT (CO Trial Ex. 11) at 16.

10. The Copyright Owners’ Revenue Definition Would Compensate Copyright Owners for All Revenue Attributable to Music

870. The Copyright Owners’ definition of revenue seeks to include all revenue that is attributable to music. 5/20/08 Tr. at 7454 (Landes). As described above, there are many different ways for record companies and digital music services to decide how they will earn revenue from the sale or use of musical works. While the owners and creators of those musical works do not have a say in the record companies’ decisions, they should

be compensated for the revenue that is fairly attributable to their creations. The Copyright Owners' revenue definition addresses the concern that Copyright Owners might not be fairly compensated for their works where copyright users do not separately charge for music or generate revenues directly from music. *Id.* at 7248-49.

871. For example, Sony BMG received an equity stake in MySpace in exchange for access to its recordings. That equity would not be included in the RIAA's proposed definition of wholesale revenue. 5/12/08 Tr. at 5718 (A. Finkelstein). *See also* RIAA Amended Proposal at 2-3. But it was indisputably given in exchange for the content, including the mechanical rights. In contrast to the RIAA's cramped definition of revenue, the Copyright Owners' revenue definition would ensure that Copyright Owners are compensated for their critical contribution to that financial deal. The Copyright Owners' definition includes as revenue "equity, security, or other financial or economic interest" pledged as consideration for licensed music. *Written Rebuttal Statement of Copyright Owners*, Ex. A at ¶ 7. Without a comprehensive definition of revenue, Copyright Owners will not be compensated for future business models where the nominal sale price may not adequately reflect the contribution of Copyright Owners. Dr. Landes testified that, "From an economic standpoint, [the Copyright Owners' revenue definition] is reasonable because it tries to capture revenue attributable to music." *Id.* at 7452.

D. The RIAA's Proposed Terms Lack Evidentiary Support

872. The RIAA has proposed the following three terms:

- **Accounting for Digital Phonorecord Deliveries:** When a digital phonorecord delivery is not distributed directly by the compulsory licensee, the digital phonorecord delivery should be treated as made, distributed, voluntarily distributed, relinquished from possession and permanently parted with in the accounting period in which it is reported to the compulsory licensee.

- **Signing statements of account:** Monthly and annual statements of account should be valid if signed by any duly authorized agent of the compulsory licensee.
- **Audit:** An audit performed in the ordinary course of business according to generally accepted auditing standards by an independent and qualified auditor should serve as an acceptable verification procedure with respect to the information that is within the scope of the audit.

RIAA Amended Proposal at 7-8.¹⁵

873. Unlike the Copyright Owners’ proposed terms, which seek to encourage timely and accurate payments to Copyright Owners, the RIAA seeks to enshrine absolution for existing delays and water down existing regulations that ensure the accuracy of reporting license use. The purpose of the regulations is to encourage compulsory licensees to account truthfully and accurately for their distribution of musical works under the compulsory licensing honor system established in Section 115 of the Copyright Act. *See* Pedecine WRT (CO Trial Ex. 394) at 2. The dilutions proposed by the RIAA will not serve that purpose.

1. Accounting for Digital Phonorecord Deliveries

874. The RIAA’s original terms proposal contained a term by the same title (“Accounting for Digital Phonorecord Deliveries”) which provided that under certain circumstances, DPDs should be treated as made and distributed in the month after they are digitally transmitted, rather than on the date the digital transmission occurs, as the current regulation provides.¹⁶ In the Matter of Mechanical and Digital Phonorecord

¹⁵ The RIAA proposed one additional term, “Clarification of Covered Reproductions,” however, this term was resolved in the parties’ May 15, 2008 Partial Settlement so Copyright Owners do not address it herein.

¹⁶ The RIAA’s complete term states: “Accounting for Digital Phonorecord Deliveries: Modify 37 C.F.R. § 201.19(a)(6) so that when a digital phonorecord delivery is

Delivery Rate Adjustment Proceeding, *Proposed Rates and Terms of the RIAA*, Docket No. 2006-3 CRB DPRA, at 5. *See also* 37 C.F.R. § 201.19(a)(6).

875. In February 2008, the RIAA conceded that this term must be withdrawn because, “[U]pon further reflection, it is now apparent that the Court may not modify the regulations under any circumstances. . . Here, because the regulation at issue involves payment issues, rather than notice or recordkeeping, the Court is barred from setting the proposed term[] instead of following the regulations.” In the Matter of Mechanical and Digital Phonorecord Delivery Rate Adjustment Proceeding, *RIAA’s Brief on the Jurisdiction of the United States Copyright Royalty Judges to Set Certain Terms and Motion to Strike Terms Outside That Jurisdiction*, Docket No. 2006-3 CRB DPRA, at 10 (February 22, 2008).

876. Two months later, the RIAA amended its terms and re-submitted an “Accounting for Digital Phonorecord Deliveries” term which appears remarkably similar to the one that the RIAA previously conceded was “barred.” The RIAA now proposes that DPDs should be treated as distributed not “in the month immediately following that in which the phonorecord is digitally transmitted,” but rather “in the accounting period in which it is reported to the compulsory licensee.” *Compare* Proposed Rates and Terms of the RIAA at 5 *with* RIAA Amended Proposal at 8. The RIAA’s amended term, however,

distributed under authority of the compulsory licensee and the applicable service does not provide a detailed accounting to the compulsory licensee until after the end of the month in which the phonorecord is digitally transmitted, the digital phonorecord delivery will be treated as made, distributed, voluntarily distributed, relinquished from possession and permanently parted with in the month immediately following that in which the phonorecord is digitally transmitted.” *Proposed Rates and Terms of the RIAA*, at 5.

is no more of a “notice and recordkeeping” term than the term proposed by the RIAA originally.

877. Even if the Court decides to consider this proposed term, the RIAA has offered no support for its argument that the regulations should be amended so that the RIAA can continue to submit late payments. Andrea Finkelstein’s written testimony argues that the reporting period is “too short” but provides no factual support for the need for such a modification. A. Finkelstein WRT (RIAA Trial Ex. 84) at 25. As described above, there are delays in payment associated with pass-through licensing arrangements and rather than compensate Copyright Owners for the late payment, the RIAA seeks to enshrine the delay in law. The RIAA’s proposed term simply legitimizes slow payment.

2. Signing Statements of Account

878. Under the current regulations, statements of account must “include the handwritten signature of the compulsory licensee,” who, in the case of a corporation, must be a “duly authorized officer of the corporation.” 37 C.F.R. § 201.19(e)(6) and (f)(6)(i). Section 115(c)(5) and the current regulations require that the statement be made under oath. The person signing the oath for each monthly statement of account under the compulsory license bears the responsibility of certifying that the contents of the monthly statement are “true, complete, and correct to the best of my knowledge, information, and belief, and are made in good faith.” 37 C.F.R. § 201.19(e)(6)(v). Requiring a corporate officer’s signature ensures that someone at the appropriate level of corporate responsibility has conducted the review and appreciates the seriousness of the consequences of any misstatement.

879. The RIAA has proposed that the CRJs weaken these requirements to permit “any duly authorized agent of the compulsory licensee” to sign statements of

account. The RIAA appears also to be suggesting that the requirement of an oath be removed, even though the statute requires it. The RIAA does not propose any mechanism for ensuring that “any duly authorized agent” would have the requisite qualifications to understand and pass judgment on the record companies’ statements of account. The RIAA’s only support for this term is that it would eliminate the need to have an officer of the corporation “sign hundreds or thousands of accounting statements each month.” A. Finkelstein WRT (RIAA Trial Ex. 84) at 25-26. However, the RIAA does not address the fact that *someone* will have to sign these accounting statements, and there is no record evidence to suggest that there is anyone as qualified as an officer of a corporation to do so.

3. Audits

880. Both Section 115 and 37 C.F.R. § 201.19(f)(6)(ii)(A) require that each annual statement of account “be certified by a licensed Certified Public Accountant.” Section 115 requires “detailed cumulative annual statements of account, certified by a certified public accountant.” 17 U.S.C. § 115(c)(5). Under Section 201.19(f)(6)(ii)(A), the CPA must certify, among other things, that an examination of the annual statement of account was conducted in accordance with generally accepted auditing standards and that the examination included tests of accounting records and other necessary auditing procedures. In addition, the CPA must certify that the annual statement of account presents fairly the number of phonorecords made and distributed and the amount of applicable royalties for the year. *See id.*

881. In the place of these longstanding and significant protections, the RIAA seeks to substitute a watered-down “audit performed in the ordinary course of business according to generally accepted auditing standards by an independent and qualified

auditor.” *Amended Proposed Rates and Terms of the RIAA* at 8. Instead of requiring a certified public accountant to conduct “tests” and a formal audit of the record company’s usage and reporting of musical works, the RIAA proposes that record companies simply use their general corporate audit to satisfy the statute’s audit requirement. The RIAA would eliminate Section 201.19(f)(6)(ii)(A)’s certification requirement as well. The RIAA’s only support for this proposal is Andrea Finkelstein’s testimony that Sony BMG already has too many audits and shouldn’t be subjected to an additional, “theoretically burdensome” one. *See* 5/12/08 Tr. at 5758-61 (A. Finkelstein); A. Finkelstein WRT (RIAA Trial Ex. 84) at 26. The RIAA has submitted no evidence to show that any such burden outweighs the benefit of having an independent, objective audit performed by a qualified professional.

4. Additional Terms

882. In addition to the three terms discussed above, the RIAA has proposed two “Additional Rate Provisions” as part of its “Alternative Rate Request.” *Amended Proposed Rates and Terms of the RIAA*, at 6-7.

- **Locked Content:** In the case of a locked content product, the product is considered distributed, and the royalty becomes payable, when the product is unlocked.¹⁷

¹⁷ The RIAA defined “locked content product” as “a phonorecord on which the sound recording has been encrypted or otherwise protected by digital rights management, or degraded (e.g., by means of voiceovers) so as not to materially substitute for the sale of a copy of a non-degraded recording, and is either (i) not otherwise accessible to, or playable in a non-degraded form by, the consumer without additional payment and/or authorization, or (ii) accessible or playable in a non-degraded form by a consumer for no more than a limited time period and/or a limited number of “plays” that is commercially reasonable for the purpose of inducing the consumer to make an additional payment to permanently obtain access to or enable the non-degraded play of the recording. A locked content product is ‘unlocked’ when a consumer is given

- **Multiple Instances:** In a case in which multiple fixations of the same sound recording are distributed on a physical product or as a la carte downloads as part of a single transaction (*e.g.*, a multisession disc, or downloads to a computer and cell phone), the price of the transaction shall be used to determine the applicable rate category, but all such fixations together shall be considered the same track.

Amended Proposed Rates and Terms of the RIAA, at 7.

(a) Locked Content

883. According to Andrea Finkelstein, “locked content” is “a recording that has been encrypted or degraded so as to be accessible in non-degraded form only for limited previewing absent a purchase transaction.” A. Finkelstein WRT (RIAA Trial Ex. 84) at 23. The RIAA has proposed that locked content should be considered “distributed” for the purposes of Section 115 only once the product is “unlocked” rather than when the product is embedded in a device or distributed to a consumer. RIAA Amended Proposal at 7; 5/12/08 Tr. at 5679 (A. Finkelstein); 5/13/08 Tr. at 6071-72 (Eisenberg).

884. As the Court recognized during the rebuttal testimony of Mark Eisenberg, the RIAA’s proposed term would require the Court to modify the statutory definition of “distribution.” *See* 5/13/08 Tr. at 6073-74 (Sledge, J.) (“So we’ll have to create a—this term would require a statutory definition of ‘distribution’ as opposed to the dictionary definition of ‘distribution’?”). The RIAA’s definition of distribution is in direct conflict with the Copyright Act’s definition of distribution: “a phonorecord is considered ‘distributed’ if the person exercising the compulsory license has voluntarily and permanently parted with its possession.” 17 U.S.C. § 115(c)(2). It also conflicts with the regulations promulgated by the Register, which provide that: “A digital phonorecord

permanent access to non-degraded play of the relevant recording.” *Amended Proposed Rates and Terms of the RIAA*, at 7.

delivery shall be treated as a phonorecord made and distributed on the date the phonorecord is digitally transmitted.” 37 C.F.R. § 201.19 (a)(6)(i).

885. The RIAA’s definition would define “distribution” as “access to the distribution of music.” *See* 5/13/08 Tr. at 6073 (Sledge, J.). For the reasons set forth above and as stated in the Copyright Owners’ Conclusions of Law, the proposed modification of Section 115 falls far beyond this Court’s scope of authority to set “reasonable terms and rates of royalty payments.” *See* 17 U.S.C. § 801(b)(1).

(b) Multiple Instances

886. The RIAA has proposed a term that would allow copyright users to pay only once for products that contain more than one fixation of a sound recording. *See Amended Proposed Rates and Terms of the RIAA*, at 7. This proposed term would affect products such as DualDiscs, SACD hybrids, and CDs with both multi-channel and stereo versions of songs. 5/12/08 Tr. at 5679 (A. Finkelstein). According to Andrea Finkelstein, “even though it is actually encoded two times,” such music should only require one license because it is “priced and marketed as one instance.” *Id.* at 5679-80.

887. The RIAA’s proposed term, however, conflicts with the Copyright Act’s provision that “the royalty under a compulsory license shall be payable for every phonorecord made and distributed in accordance with the license.” 17 U.S.C. § 115(c)(2). Rather than compensating Copyright Owners for each copy “made and distributed,” the RIAA’s proposed term would eliminate payments for certain works.

888. The proposed term also involves payment issues, which the RIAA has conceded fall outside the Court’s limited authority. *See* In the Matter of Mechanical and Digital Phonorecord Delivery Rate Adjustment Proceeding, *RIAA’s Brief on the Jurisdiction of the United States Copyright Royalty Judges to Set Certain Terms and*

Motion to Strike Terms Outside That Jurisdiction, Docket No. 2006-3 CRB DPRA, at 10 (noting that “because the regulation at issue involves payment issues, rather than notice or recordkeeping, the Court is barred from setting the proposed term[] instead of following the regulations”). *See also* Copyright Owners’ Proposed Conclusions of Law.

E. DiMA’s Proposed Terms

889. The Copyright Owners are not submitting findings of fact regarding DiMA’s proposed terms because, as discussed in Section II.D.5, the parties entered into a Partial Settlement on May 15, 2008 which included rates and terms for limited downloads and interactive streaming. DiMA’s proposed terms were addressed in the parties’ Partial Settlement.

XVII. The Creation of Mastertones Is Not a Rote Process, But a Creative One that Results in Musically Balanced Compositions

890. In contrast to the RIAA’s conclusory claims throughout this proceeding that mastertones are created in a routine fashion and are not complete musical works (and in contrast to the Ringtones Opinion), the evidence in fact established that the creation of the mastertones submitted to the Court during the direct case hearing and played for the Register at the hearing on the Referral Motion required creative and musical judgments, and that these mastertones are complete, musically balanced works. *Compare* Finell WRT (CO Trial Ex. 420) at 7-8, 26-30 (mastertone creation requires musical judgments and results in complete, balanced works); 5/21/08 Tr. at 7666, 7670-71 (Finell) (same) *with* Introductory Memorandum to the Written Direct Statement of the Recording Industry Association of America, Inc., Docket No. CRB DPRA 2006-3 (Nov. 30, 2006) at 10 (“typical mastertones are nothing more than the excerpts of recordings that have been processed to meet various technical specifications”); Reply Brief of the Recording

Industry Association of America, Inc. Addressing Novel Questions of Law on Referral to the Register of Copyrights, Docket No. CRB DPRA 2006-3 (Sept. 13, 2006) at 12, 13 (“Ringtones are . . . merely partial copies. . . . Mastertones . . . do not ‘stand on their own.’”).¹⁸

891. In the rebuttal phase of the proceeding, the Copyright Owners presented the testimony of musicologist Judith Finell, who performed a detailed musical analysis of two sets of mastertones.¹⁹ Based on this analysis, Ms. Finell reached several conclusions concerning how the mastertones had been created. In sum, Ms. Finell determined that mastertones “resulted from a whole series of creative choices that were made by the creator of the mastertone. It took musical intelligence, and it took quite a bit of musical training to have made the choices that were made.” 5/21/08 Tr. at 7666; Finell WRT (CO Trial Ex. 420) at 7-8, 26-30; *cf.* 2/14/08 Tr. at 3534 (Rosen) (explaining that mastertones are created by “experts on the staff . . . that have that backgrounds that come with that

¹⁸ Jerold Rosen, the only witness presented by the RIAA in support of its position that creating mastertones is a routine process, conceded at trial he had no personal knowledge concerning the current creation of ringtones. 2/14/2008 Tr. at 3539 (Rosen). Accordingly, the Court struck the bulk of his written statement, and all the portions concerning the artistic process of creating mastertones, from the record. *Id.* at 3544-50.

¹⁹ Ms. Finell analyzed: (1) the mastertones submitted as an exhibit to the Written Direct Statement of J.J. Rosen (the “Sony BMG Mastertones”), which included mastertones derived from “Irreplaceable,” performed by Beyoncé; “. . . Baby One More Time,” performed by Britney Spears; “Girls Just Want to Have Fun,” performed by Cyndi Lauper; “That’s All Right,” performed by Elvis Presley; “My Love” and “SexyBack,” performed by Justin Timberlake; and “Over My Head,” performed by The Fray, *see* RIAA Trial Ex. 63, Ex. 101DP; Finell WRT (CO Trial Ex. 420) at 5-6, and (2) two of the mastertones presented to the Register of Copyrights during the hearing on the Referral Motion, which included Hollaback Girl,” performed by Gwen Stefani and “Gimme Shelter,” performed by The Rolling Stones. *See id.* at 8 n.6; *see also id.* at 3-7 (describing Ms. Finell’s methodology); 5/21/08 Tr. at 7663-64 (Finell) (same).

knowledge”); *see also id.* at 3525-26 (explaining that historically, the Sony BMG digital operations group, which is responsible for ringtones, had a staff of sound engineers with an understanding of musical composition).

A. Making Mastertones Is a Creative Process

892. Ms. Finell identified several creative steps involved in the creation of mastertones. *See generally* Finell WRT (CO Trial Ex. 420). First, the mastertone creator must choose a segment of the sound recording to use as a mastertone. *Id.* at 7, 27; 5/21/08 Tr. at 7666-7667 (Finell). As Ms. Finell explained, this choice is a creative one. Many songs have a primary “hook”—meaning the signature phrase usually (but not always) associated with the song’s title lyrics—and also contain secondary hooks and other recognizable passages that are appropriate candidates for the mastertone segment. Finell WRT (CO Trial Ex. 420) at 27; *see also* 5/21/08 Tr. at 7665-67 (Finell). For example, the song “Irreplaceable” includes a primary hook that repeats sixteen times, a secondary hook that repeats four times, and “a prominent secondary phrase” that repeats throughout the song. Finell WRT (CO Trial Ex. 420) at 14-15; *see also* 5/21/08 Tr. at 7664-65 (Finell). Because, as Ms. Finell explained in her report, “these segments of the work are by definition recognizable and thus will on their own evoke to the consumer the underlying work, the decision as to which segment to use for a mastertone represents a creative judgment made by its creator.” Finell WRT (CO Trial Ex. 420) at 27; *see also* 5/21/08 Tr. at 7667 (Finell).

893. The creativity involved in this step is further illustrated by the existence in the market of multiple mastertones derived from the same sound recording. Finell WRT (CO Trial Ex. 420) at 27. For example, Ms. Finell analyzed three mastertones derived from each of the songs “Irreplaceable,” “Girls Just Want to Have Fun,” “My Love” and

“Over My Head” and two mastertones derived from each of the songs “. . .Baby One More Time,” “That’s All Right” and “SexyBack.”²⁰ Along the same lines, Mr. Rosen testified that Sony BMG creates multiple mastertones from the same sound recording based upon what Sony BMG mastertone creators think “works best creatively.” 2/14/08 Tr. at 3519 (Rosen).

894. Moreover, although many of the mastertones that Ms. Finell analyzed include the primary hook from the original sound recording, many did not. *See* Finell WRT (CO Trial Ex. 420), Exs. F-2, F-4, F-6, C-9. (Mastertones derived from “. . . Baby One More Time,” “That’s All Right,” “SexyBack” and “Hollaback Girl” did not include a primary hook.)

895. Second, after the mastertone creator chooses a segment to use for the mastertone, he or she must determine which version of the chosen segment to use for the mastertone. As Ms. Finell observed, “[t]he very nature of a hook or recognizable passage requires that it be used repeatedly in a song.” Finell WRT (CO Trial Ex. 420) at 27; *see also* 5/21/08 Tr. at 7667-68 (Finell). In “Irreplaceable,” as noted above, the lyrics of the hook appear in the song sixteen times. Similarly, Ms. Finell’s analysis showed that in “Girls Just Want to Have Fun,” the hook repeats fourteen times and in “That’s All Right” the primary hook and variations occur eleven times. CO Trial Ex. 420, Exs. F-4, F-5; *see also id.* Exs. F-6; F-7; F-9.

896. Typically, various iterations of the hook or other chosen segment differ. As Ms. Finell explained, “[i]f there’s a hook that’s used 15 and 20 times in a song, some

²⁰ *See* Finell WRT (CO Trial Ex. 420) at 13-22; CO Trial Ex. 420, Exs. C-1–C-7. Notably, the two mastertones derived from “SexyBack” include different lyrics and music, and were taken from different portions of the original song. *See id.*, Ex. C-6.

hooks will be more complicated than others, some will be simpler to follow, others will have instruments playing in the background that distract the ear and make it more complex.” 5/21/08 Tr. at 7668 (Finell); *see also* Finell WRT (CO Trial Ex. 420) at 27-28.

897. In the full-length recording of “Irreplaceable,” Ms. Finell identified several “simple and unadorned” versions of the hook and several other complex versions, that “included embellishment.” Finell WRT (CO Trial Ex. 420) at 16. Thus, as Ms. Finell opined, the decision of which iteration of a segment to use for the mastertone is an artistic decision, which requires musical judgment as to which iteration will best achieve the artistic goals of the creator. Finell WRT (CO Trial Ex. 420) at 28. 5/21/08 Tr. at 7668 (Finell) (“So it takes musical ears, in a way, to determine which of similar phrases to use.”).

898. Third, the mastertone creator must decide how to edit the mastertone. Finell WRT (CO Trial Ex. 420) at 28; 5/21/08 Tr. at 7679-80 (Finell). This step requires the creator to determine “precisely where to begin and end the mastertone, in terms of exactly which material to include.” Finell WRT (CO Trial Ex. 420) at 28. Ms. Finell illustrated the creative decisions involved in editing through her discussion of “Gimme Shelter,” in which the mastertone creator chose to include in the mastertone a cymbal crash right before the first iteration of the song’s hook. As she explained, the mastertone creator could have chosen to begin the mastertone with the famous hook, “war children . . . and that could have been a very good place to start. But instead by starting with the [cymbal] that is played right before it . . . it really wakes up the listener. It creates a

whole frame for what's about to follow. And it was clearly an artistic decision to include that." 5/21/08 Tr. at 7669 (Finell).

899. Ms. Finell further explained that additional creative decisions are involved in those mastertones designed to "loop," that is, to repeat as a mobile phone continues to ring. Looped mastertones are edited in such a way that the endpoint of the mastertone and the beginning point of the mastertone blend harmonically, rhythmically and structurally so that there is musical flow as the mastertone repeats. Finell WRT (CO Trial Ex. 420) at 17, 28; *see also* 5/21/08 Tr. at 7670 (Finell).

B. Mastertones Are Musically Balanced Musical Compositions

900. In direct conflict with the RIAA's self-serving assertions that mastertones are just excerpts of sound recordings, Ms. Finell further concluded that each of the mastertones that she analyzed was "musically balanced, independent, and contain[] many of the same fundamental technical elements that constitute full-scale musical works." Finell WRT (CO Trial Ex. 420) at 29. She explained that although mastertones "[o]f course . . . were derived from a fuller length recording[s], . . . exactly what was . . . chosen to be used . . . became its own musical work." 5/21/08 Tr. at 7671 (Finell).

901. As an example, Ms. Finell illustrated how one of the "Irreplaceable" mastertones "stands on its own as a musically-balanced composition" because of its question and response structure. In addition, it does not sound fragmentary because it does not include distracting elements, such as overlapping vocal melodies. Finell WRT (CO Trial Ex. 420) at 15-16; 5/21/08 Tr. at 7681-82 (Finell). Ms. Finell further explained that both "Irreplaceable" mastertones are structurally complete because they include a

beginning, middle and end, as well as traditional harmonic structures. Finell WRT (CO Trial Ex. 420) at 20, 22.²¹

902. In sum, Ms. Finell concluded: “The creation of mastertones is not a rote process. Rather, it involves a combination of many of the same creative decisions used to create any other musical work that is musically balanced and complete.” Finell WRT (CO Trial Ex. 420) at 26. Ms. Finell also opined that although mastertones “derive from longer musical works, they have been transformed into independent musical compositions possessing their own aesthetic integrity, and are compositions that, as free-standing units, differ substantially from their source recordings.” *Id.* at 29. She further explained that “mastertones are not mere ‘excerpts’ of sound recordings. . . . Despite their actual ancestry, they have become independent ‘emancipated’ works through a creation process involving musical skill, originality, and creativity.” *Id.* at 30.

C. Sony BMG’s Guidelines Contradict the RIAA’s Arguments

903. Critically, despite the RIAA’s constant refrain that mastertones do not involve creative judgments and are not complete works, the only internal document about the creation of mastertones in the record from a record company—the “Sony BMG Guidelines,” which provides artistic guidance for Sony BMG employees who create mastertones—proves the precise opposite. *See* Finell WDT (CO Trial Ex. 420), Ex. E at RIAA 10313.

904. The Sony BMG Guidelines set forth certain judgments made by Sony BMG as to the musical and creative characteristics that a mastertone should embody. As expressly stated in the Sony BMG Guidelines, the goal of the creator should be to create

²¹ Mr. Rosen agreed that mastertones should make musical sense on their own. 2/14/08 Tr. at 3539-40 (Rosen).

a mastertone that is an “indivisible musical unit” and, where possible, “musically balanced” and “hermetically sealed,” and that does not sound like a “fragment[]” of something else. Finell WRT (CO Trial Ex. 420) at 23; *see also* 5/21/08 Tr. at 7683 (Finell). To those ends, the Sony BMG Guidelines discuss: (1) how to choose the relevant passages of a recording for a mastertone; (2) how to choose between different versions or iterations of the segment chosen; (3) how to “frame” the segment so that the mastertone is sonically pleasing; and (4) how to create mastertones that are intended to loop.

905. Thus, the Sony BMG Guidelines—which express Sony BMG’s judgment as to what mastertones should be—confirm that the creative steps outlined by Ms. Finell are involved in the creation of mastertones and that the goal of Sony BMG and its creators is to create mastertones that are complete, balanced works. Further, Ms. Finell concluded that the Sony BMG mastertones that she analyzed in connection with her report were created consistent with the Sony BMG Guidelines. *See* Finell WRT (CO Trial Ex. 420) at 23.

906. In sum, all of the evidence in the record relating to the creation of mastertones is in clear conflict with the RIAA’s claims that mastertones are mere “excerpts of recordings” and with the Register’s ruling that certain mastertones “do not contain any originality and are created with rote editing.” *Ringtones Opinion*, 71 Fed. Reg. at 64313.

Conclusion

For the foregoing reasons, and those set forth in the Proposed Conclusions of Law, the Copyright Owners respectfully request that the Copyright Royalty Judges adopt the proposals set forth in the Amended Proposed Rates and Terms of National Music Publishers' Association, Inc., the Songwriters Guild of America, and the Nashville Songwriters Association International, dated July 2, 2008.

Dated: July 2, 2008

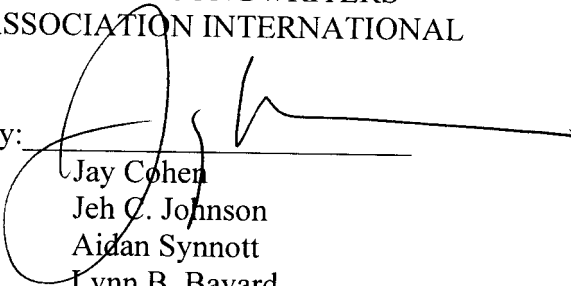
Respectfully submitted,

NATIONAL MUSIC PUBLISHERS'
ASSOCIATION, INC.

THE SONGWRITERS GUILD OF
AMERICA

NASHVILLE SONGWRITERS
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APPENDIX A

Before the
UNITED STATES COPYRIGHT ROYALTY JUDGES
Washington, D.C.

In the Matter of)	
MECHANICAL AND DIGITAL PHONORECORD DELIVERY RATE ADJUSTMENT PROCEEDING)	Docket No. 2006-3 CRB DPRA

**AMENDED PROPOSED RATES AND TERMS OF THE
RECORDING INDUSTRY ASSOCIATION OF AMERICA, INC.**

Pursuant to Sections 351.11 and 351.4(b)(3) of the Copyright Royalty Judges' Rules and Procedures, 37 C.F.R. §§ 351.11, 351.4(b)(3), the Recording Industry Association of America, Inc. ("RIAA"), proposes the following rates and terms for the Section 115 compulsory license. Pursuant to 37 C.F.R. § 351.4(b)(3), RIAA reserves the right to alter or amend its proposal prior to or at the time of submission of its proposed findings of fact and conclusions of law, if warranted by the record.

I. Royalty Rates

The royalty payable under Section 115 for the use of a musical work in a sound recording contained on any phonorecords of the following types distributed during any payment period after the effective date of the Copyright Royalty Judges' determination should be at a percentage of the licensee's all-in wholesale revenue directly attributable to distribution of such phonorecords during the payment period and allocable to that sound recording, as described below:

A. Physical Products, Downloads, Limited Downloads and Other Digital Phonorecord Deliveries in General (But Not Ringtones)

In the case of phonorecords distributed by the licensee's physically parting with possession of such phonorecords, and in the case of phonorecords distributed as digital phonorecord deliveries, except as provided in Parts I(B) and (C) below – 9%.

B. Ringtones

In the case of ringtones – 15%.

Definition:

For this purpose a “ringtone” is a phonorecord of a partial musical work distributed as a digital phonorecord delivery and made resident on a telecommunications device for use to announce the reception of an incoming telephone call or other communication or message or to alert the receiver to the fact that there is a communication or message.

C. On-Demand Streams and Other Incidental Digital Phonorecord Deliveries

In the case of on-demand streams and any other digital phonorecord deliveries (“DPDs”) where the reproduction or distribution of a phonorecord is incidental to the transmissions which constitute the DPDs – 1.1%.

Definition:

For this purpose –

- An “on-demand stream” is an on-demand, real-time digital transmission of a sound recording of a musical work to allow a user to listen to a particular sound recording chosen by the user at a time chosen by the user, using streaming technology that is configured in a manner designed so that such transmission will not result in a substantially complete reproduction of a sound recording being made on a local storage device for listening other than at substantially the time of the transmission.

II. Calculation of Royalties

A. Definition of Wholesale Revenue

For purposes of Parts I(A) through (C) above, when the licensee is not distributing phonorecords directly to end user consumers (e.g., when a record company is selling a physical product to a distributor, or authorizing a digital music service to make digital phonorecord deliveries), the licensee’s “all-in wholesale revenue directly attributable to distribution of phonorecords during a rate period” shall mean revenue recognized by the licensee in accordance with Generally Accepted Accounting Principles from the distribution of such phonorecords, and shall be comprised of the following:

- (i) in the case of physical products, sales revenue recognized by licensee directly from distribution of phonorecords, meaning gross sales as reflected on the applicable invoices, less returns and applicable sales discounts; and
- (ii) in the case of digital phonorecord deliveries, sales, licensing and other revenues received from digital music services attributable to distribution

of the relevant sound recording and the musical work embodied therein, as reflected in sales reports and accountings provided to the licensee by such services.

The licensee's wholesale revenues shall include such payments as set forth in paragraphs (i) and (ii) above to which the licensee is entitled but which are paid to a parent, wholly owned subsidiary or division of licensee.

The licensee's wholesale revenues shall exclude sales and use taxes, shipping, and handling and insurance charges.

The foregoing assumes that licensees will be permitted to reserve for returns as provided in the Copyright Office's regulations implementing Section 115 of the Copyright Act (37 C.F.R. § 201.19).

B. Digital Music Service as Licensee

In a case in which the licensee is a digital music service that has been authorized by the copyright owner of a sound recording to distribute phonorecords of the sound recording by means of a digital phonorecord delivery but that has itself acquired licenses under Section 115, the applicable royalties under Part I above shall be the percentage set forth in Part I of the equivalent "all-in" royalty (i.e., the royalty payable for sound recordings plus the royalty payable for mechanical rights to musical works). Thus, the rate under Part I(A) would be 9.9% of the amount paid by the service to the record company for use of the sound recording only; the rate under Part I(B) would be 17.6% of the amount paid by the service to the record company for use of the sound recording only; and the rate under Part I(C) would be 1.1% of the amount paid by the service to the record company for use of the sound recording only.

Note:

This is a mathematically equivalent expression of the same approach proposed by the Copyright Owners when they request a royalty rate based on "total content costs." A royalty rate for musical works expressed as a percentage of the sound recording royalty that is the equivalent of a royalty rate for musical works expressed as a percentage of the combined musical work and sound recording royalty can be determined by the following formula:

$$P_{RR} = \frac{P_{CR}}{100 - P_{CR}}$$

where P_{RR} = the percentage of the recording royalty, and
 P_{CR} = the percentage of the combined (or all-in) royalty

Thus, for example, under RIAA's rate request in Part I(A), a record company that received \$1 from a service for the use of a musical work and sound recording in a download would pay a mechanical royalty of \$0.09. If instead the record company and service agreed that the service would pay the \$0.09 in mechanical royalties directly, the record company would receive \$0.91 cents for the use of the sound recording only. The \$0.09 in mechanical royalties to be paid directly is 9.9% of the \$0.91 cent payment to the record company for sound recording rights alone.

C. Record Company as Direct Retailer

In a case in which the licensee is a copyright owner of sound recordings that is distributing phonorecords directly to end user consumers, "the licensee's all-in wholesale revenue directly attributable to distribution of phonorecords during a rate period" shall mean the licensee's revenue from such distribution multiplied by the applicable percentage from the table below:

Configuration	Percentage
Physical and Permanent Download	70%
Other	50%

D. Calculation of Royalty Base for Bundles

If, in a single transaction, a licensee receives payment for sound recordings of musical works distributed pursuant to Section 115 and subject to the rate provided in any one of Parts I(A) through (C), as well as other products or services (e.g., where a phonorecord or online bundle contains material other than sound recordings of musical works), the licensee's revenues from the transaction shall be attributed to the sound recordings of musical works and other products or services in proportion to the licensee's published prices thereof when distributed separately, if any, or otherwise in accordance with a reasonable and non-discriminatory allocation methodology consistently applied.

E. Allocation of Royalty among Musical Works

If, in a single transaction, a licensee receives payment for sound recordings of multiple unique musical works distributed pursuant to Section 115 and subject to one of Parts I(A) through (C) (e.g., the tracks on a CD or a digital album), the applicable revenues shall be allocated equally among such musical works.

III. Transition Period

To allow copyright owners and licensees reasonable time to implement the percentage royalty structure described above --

(i) these rates should be effective on the first day of the first calendar quarter beginning more than six months after the publication of the determination of the Copyright Royalty Judges in the Federal Register; and

(ii) in the case of any phonorecord first released to the public prior to such date, for the 12 months following such date, the licensee shall have the option to pay royalties at the rates set forth above or the statutory rate previously in effect.

IV. Alternative Rate Request (Not RIAA's Preferred Approach)

RIAA believes that a percentage royalty rate structure is most appropriate for all the reasons explained in the testimony it has presented, and RIAA does not advocate for a cents-rate royalty for any category of product or service. However, in the event that the Copyright Royalty Judges determine that a percentage royalty structure is not appropriate for any category of product or service, RIAA has set forth below an alternative rate proposal including cents rates designed to approximate its percentage rate proposals for certain configurations.

Rate Category	Rate	Basis for Rate
Premium Price Physical Product or a la Carte Download (Wholesale price \$1/track or more)	9.45¢/track	Wholesale price of \$1.05 x 9%. E.g.: <ul style="list-style-type: none"> • \$1.05 per track wholesale price for physical album with wholesale price of \$10.50 and 10 tracks¹ • \$1.04 wholesale price for single download having a \$1.49 retail price
High Price Physical Product or a la Carte Download (Wholesale price 80¢/track or more but less than \$1/track)	8.1¢/track	Wholesale price of 90¢ x 9%. E.g.: <ul style="list-style-type: none"> • 90¢ per track wholesale price for physical album with wholesale price of \$9 and 10 tracks • 90.3¢ wholesale price for single download having a \$1.29 retail price
Medium Price Physical Product or la Carte Download (Wholesale price 60¢/track or more but less than 80¢/track)	6.3¢/track	Wholesale price of 70¢ x 9%. E.g.: <ul style="list-style-type: none"> • 69¢ per track wholesale price for physical album with wholesale price of \$9 and 13 tracks • 70¢ wholesale price for single download having a 99¢ retail price

¹ RIAA understands there to be approximately 13 tracks per album on average, but the range in the number of tracks per album is wide. Ten tracks is used here as an example of a product that would warrant the proposed per-track payment based on existing economic conditions.

Low Price Physical Product or a la Carte Download (Wholesale price 45¢/track or more but less than 60¢/track)	4.7¢/track	Wholesale price of 52.5¢ x 9%. E.g.: <ul style="list-style-type: none"> • 53.8¢ per track wholesale price for physical album or album download with wholesale price of \$7 and 13 tracks • 55.3¢ wholesale price for single download having a 79¢ retail price
Very Low Price Physical Product or a la Carte Download (Wholesale price less than 45¢/track)	3.6¢/track	Wholesale price of 40¢ x 9%. E.g.: <ul style="list-style-type: none"> • 38.5¢ per track wholesale price for physical album with wholesale price of \$5 and 13 tracks • 43¢ per track wholesale price for album download having a wholesale price of \$5.59 (retail \$7.99) and 13 tracks
Ringtone	18¢	\$1.20 wholesale price x 15%
On-Demand Streams and Other Incidental Digital Phonorecord Deliveries - Promotional	Zero	Zero revenues
Other DPDs in General	9% of wholesale	Rate under Part I(A) above
On-Demand Streams and Other Incidental Digital Phonorecord Deliveries - Non-Promotional	1.1% of wholesale	Rate under Part I(C) above

Definition:

For this purpose an on-demand stream or other incidental DPD is “promotional” if (i) it is made or authorized by or under the authority of the sound recording copyright owner; (ii) the primary purpose of the sound recording copyright owner in making or authorizing the incidental DPD is to promote sales or any other paid uses of recordings by the artist or paid use of a service through which an artist’s recordings are available; (iii) the incidental DPD is offered free to the end user; and (iv) in the case of an incidental DPD through a third party site, the sound recording copyright owner does not receive any cash or other monetary payment for the incidental DPD.

Additional Rate Provisions:

If the Copyright Royalty Judges adopt cents rates such as those set forth above, the adjustments in Parts II(B) and (C) should apply where applicable, and revenues from bundles should be allocated as provide in Part II(D), to calculate the per-track wholesale price. The following additional provisions concerning calculation of the royalty also should apply:

A. Locked Content

In the case of a locked content product, the product is considered distributed, and the royalty becomes payable, when the product is unlocked.

Definitions:

For this purpose –

- A “locked content product” is a phonorecord on which the sound recording has been encrypted or otherwise protected by digital rights management, or degraded (e.g., by means of voiceovers) so as not to materially substitute for the sale of a copy of a non-degraded recording, and is either (i) not otherwise accessible to, or playable in a non-degraded form by, the consumer without additional payment and/or authorization, or (ii) accessible or playable in a non-degraded form by a consumer for no more than a limited time period and/or a limited number of “plays” that is commercially reasonable for the purpose of inducing the consumer to make an additional payment to permanently obtain access to or enable the non-degraded play of the recording.
- A locked content product is “unlocked” when a consumer is given permanent access to non-degraded play of the relevant recording.

B. Multiple Instances

In a case in which multiple fixations of the same sound recording are distributed on a physical product or as a la carte downloads as part of a single transaction (e.g., a multisession disc, or downloads to a computer and cell phone), the price of the transaction shall be used to determine the applicable rate category, but all such fixations together shall be considered the same track.

V. Terms

RIAA proposes the following terms that would apply notwithstanding anything to the contrary in 37 C.F.R. § 201.19:

A. Clarification of Covered Reproductions

Regulations should confirm that a compulsory license under Section 115 extends to all reproductions necessary to engage in activities covered by the compulsory license, including –

- (1) the making of reproductions by and for end users;

- (2) reproductions made on servers under the authority of the licensee;
and
- (3) incidental reproductions made under the authority of the licensee
in the normal course of engaging in such activities, including
cached, network, and buffer reproductions.

B. Accounting for Digital Phonorecord Deliveries

When a digital phonorecord delivery is not distributed directly by the compulsory licensee, the digital phonorecord delivery should be treated as made, distributed, voluntarily distributed, relinquished from possession and permanently parted with in the accounting period in which it is reported to the compulsory licensee.

C. Signing Statements of Account

Monthly and annual statements of account should be valid if signed by any duly authorized agent of the compulsory licensee.

D. Audit

An audit performed in the ordinary course of business according to generally accepted auditing standards by an independent and qualified auditor should serve as an acceptable verification procedure with respect to the information that is within the scope of the audit.

Respectfully Submitted,



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April 10, 2008

APPENDIX B

EXHIBIT A:

AMENDED PROPOSED RATES AND TERMS OF DiMA

Add the following to Chapter III of title 37, Code of Federal Regulations (tentatively numbered part 380 for purposes of reference):

PART 380 – RATES AND TERMS UNDER COMPULSORY LICENSE FOR MAKING AND DISTRIBUTING A DIGITAL PHONORECORD DELIVERY

Sec.

380.1 General.

380.2 Definitions.

380.3 Royalty rates.

380.4 Scope of statutory license.

§ 380.1 General.

This part 380 establishes rates and terms of royalty payments for all copies made in the course of making and distributing phonorecords, including by means of digital phonorecord delivery, in accordance with the provisions of 17 U.S.C. 115.

§ 380.2 Definitions.

(a)(1) *Applicable receipts* means that portion of the money received by the licensee, or licensee's carrier(s), from the provision of a digital phonorecord delivery that shall be comprised of the following:

- (i) revenue recognized by the licensee from residents of the United States in consideration for the digital phonorecord delivery in accordance with the provisions of 17 U.S.C. 115; and

- (ii) the licensee's advertising revenues attributable to third party advertising "in download", being advertising placed immediately at the start, end or during the actual delivery of a digital phonorecord, less advertising agency and sales commissions.

Note: Notwithstanding (i) and (ii), above, the licensee may pro-rate or allocate revenue on the basis of total usage of digital phonorecord deliveries of sound recordings or on any other reasonable basis that fairly and accurately reflects the revenues attributable to particular uses. For example, if revenue is received for a bundle or package, the licensee may allocate revenues on the basis of usage (if DPDs comprise half of total usage, then half of all revenues are attributed to them).

(2) Applicable receipts shall include such payments as set forth in paragraph (a) of this section to which the licensee, or licensee's carrier, is entitled but which are paid to a parent, majority-owned subsidiary or division of the licensee.

(3) Applicable receipts shall exclude:

- (i) revenues attributable to the sale and/or license of equipment and/or technology, including bandwidth, including but not limited to sales of devices that receive or perform the licensee's digital phonorecord deliveries and any taxes, shipping and handling fees therefore;
- (ii) royalties paid to the licensee for intellectual property rights;
- (iii) sales and use taxes, shipping and handling, credit card and fulfillment service fees paid to third parties;
- (iv) bad debt expense; and

(v) advertising revenues other than those set forth in paragraph (a)(1)(ii) of this section.

(b) *Digital phonorecord delivery* means a digital phonorecord delivery as defined in 17 U.S.C. 115(d).

(c) *Permanent digital phonorecord delivery* means a digital phonorecord delivery that is distributed in the form of a download that may be retained and played on a permanent basis.

(d) *Limited digital phonorecord delivery* means a digital phonorecord delivery that is distributed in the form of a download that is (1) available to the recipient regardless of maintaining a data connection to the licensee but (2) restricted from being retained and/or played on a permanent basis.

(e) *Incidental digital phonorecord delivery* means a digital phonorecord delivery (1) where the reproduction or distribution of a phonorecord is incidental to the transmission which constitutes the digital phonorecord delivery to a user, and (2) that is delivered solely by or at the instruction of the licensee to facilitate the public performance of a specific phonorecord in direct response to the user's request for the immediate performance of the specific phonorecord.

(f) *Licensee* means a person or entity that has obtained a compulsory license under 17 U.S.C. 115 and the implementing regulations therefore to make and distribute phonorecords, including by means of digital phonorecord delivery.

(g) *Licensee's carriers* means the persons or entities, if any, authorized by Licensee to distribute digital phonorecord deliveries to the public.

(h) *Licensed work* means the nondramatic musical work embodied or intended to be embodied in a digital phonorecord delivery made under the compulsory license.

(i) A *playback* is any play of greater than 30 seconds by an end user during an accounting period of a phonorecord of the licensed work distributed by limited digital phonorecord delivery.

(j) A *subscriber* is a natural person who receives a limited digital phonorecord delivery for private and noncommercial use as part of a subscription offered by the licensee; pays a regular fee in order to access the subscription; and gains access to and is able to playback the limited digital phonorecord delivery only while such regular fee is paid and controlled by digital rights management technology.

§380.3 Royalty Rates.

(a) For a permanent digital phonorecord delivery, the royalty rate payable shall be the greater of (i) 6% of applicable receipts or (ii) 4.8 cents per track for single tracks or 3.3 cents per track for tracks sold as part of a single transaction including more than a single track (“bundles”).

(b) For a limited digital phonorecord delivery, the royalty rate payable shall be equal to the greater of

- (i) 5.9% of applicable receipts from said delivery during an accounting period times a fraction, (A) the numerator of which shall be the number of playbacks of all phonorecords of the licensed work and (B) the denominator of which shall be the total number of playbacks of all phonorecords of all licensed works or

(ii) (A) where the delivery is to a subscriber then 13.5 cents per-subscriber-per-month times a fraction, (1) the numerator of which shall be the number of playbacks of all phonorecords of the licensed work and (2) the denominator of which shall be the total number of playbacks of all phonorecords of all licensed works or (B) where the delivery is not to a subscriber then \$0.00129 per playback.

(c) In compliance with section 17 U.S.C. § 115(c), to distinguish the rates and terms for incidental and other digital phonorecord deliveries, the rate for an incidental digital phonorecord delivery shall be zero.

(d) In any case in which royalties must be allocated to specific musical works under subsection (a) or (b), each unique musical work's share shall be determined on a pro rata basis.

(e) In any future proceeding under 17 U.S.C. 115(c)(3)(C) or (D), the royalty rates payable for a compulsory license for any digital phonorecord deliveries shall be established de novo, and no precedential effect shall be given to the royalty rate payable under this paragraph for any period prior to the period as to which the royalty rates are to be established in such future proceeding.

§380.4 Scope of statutory license.

A compulsory license under 17 U.S.C. 115 extends to, and includes full payment for, all reproductions necessary to engage in activities covered by the license, including but not limited to:

(a) the making of reproductions by and for end users;

(b) all reproductions made in the normal course of engaging in such activities, including but not limited to masters, reproductions on servers, cached, network, and buffer reproductions.

CERTIFICATE OF SERVICE

I hereby certify that on this 2nd day of July 2008, I caused true and correct copies of the restricted and public versions of the Copyright Owners' Proposed Findings of Fact to be served in hard copy, as well as on CDs containing the same document in PDF format, via Federal Express on the following parties:

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I further certify that on this 2nd day of July 2008, I caused a true and correct copy of the public version of the Copyright Owners' Proposed Findings of Fact to be served on CD in PDF format via Federal Express on the following parties:

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