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

CO Trial
Ex. 406

In the Matter of Mechanical and Digital Phonorecord Delivery Rate Adjustment Proceeding	Docket No. 2006-3 CRB DPRA

REBUTTAL REPORT OF WILLIAM M. LANDES ON BEHALF OF NATIONAL MUSIC PUBLISHERS' ASSOCIATION, INC., THE SONGWRITERS GUILD OF AMERICA AND THE NASHVILLE SONGWRITERS ASSOCIATION INTERNATIONAL

I. INTRODUCTION AND SUMMARY

1. I, William M. Landes, previously submitted written direct testimony[1] and testified at trial during the direct phase of this proceeding, at which time I was qualified as an expert. I have been asked by counsel for National Music Publishers' Association, Inc., the Songwriters Guild of America, and the Nashville Songwriters Association International (collectively, the "Copyright Owners") to respond to issues raised in the reports filed and testimony given by Professor David J. Teece on behalf of the Recording Industry Association of America, Inc. ("RIAA") and by Margaret Guerin-Calvert on behalf of the Digital Media Association ("DiMA").

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[1] Amended Expert Report of William M. Landes, on Behalf of National Music Publishers' Association, Inc., the Songwriters Guild of America and the Nashville Songwriters Association International, October 29, 2007 ("Landes Report").

2. In preparing this rebuttal report, I reviewed the written direct testimony of Professor Teece and Ms. Guerin-Calvert, as well as their deposition and trial transcripts. I also acquired additional data from music publishers concerning mechanical and other royalty income.[2]

3. Both Professor Teece and Ms. Guerin-Calvert propose a significant reduction in the statutory rate and a change in its structure from a per-unit fee to a uniform percent of revenue. As I explain in this report, neither Professor Teece nor Ms. Guerin-Calvert considers the likely harmful economic effects of the rates and rate structure they advocate. Their proposals conflict with the underlying objectives of Section 801(b) of the Copyright Act – to provide incentives to create and distribute new music. Because the statutory rate sets a ceiling on royalties that Copyright Owners receive, the reductions in the statutory rate they propose would reduce the economic incentives to songwriters (both current and prospective) to create new songs. A statutory rate that is too low, by which I mean lower than would arise in a competitive market, would 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. In the long run, fewer new songs would be produced and distributed, and ultimately social welfare would decline.

4. On the other hand, as I stated in my direct testimony, if the Copyright Royalty Judges ("CRJs") were to establish a compulsory rate that is too high for some users, it

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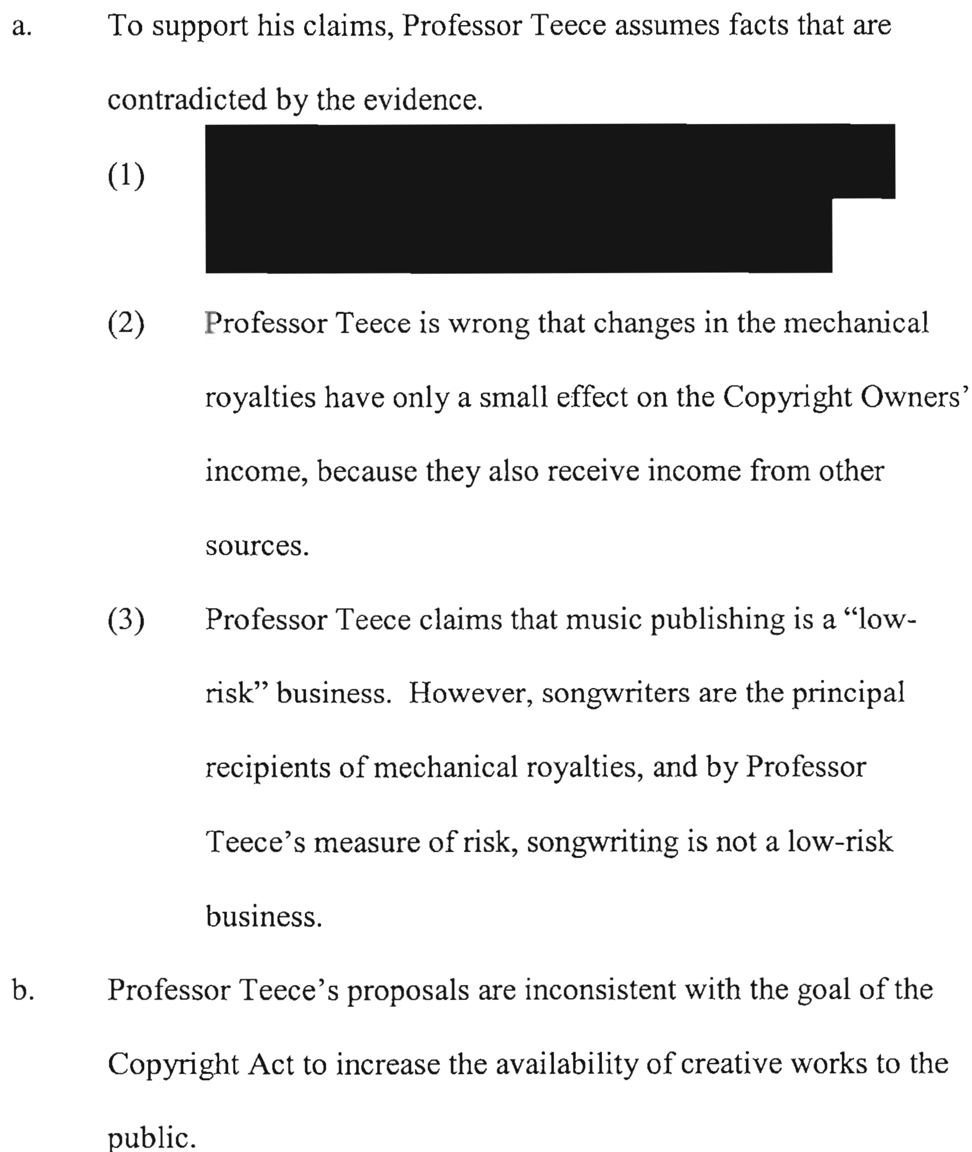
2 A list of materials I have reviewed in connection with this report is attached as Exhibit A.

would be in the economic interest of both the Copyright Owners and those potential users to negotiate rates below the statutory rate that are beneficial to both parties. That is, assuming it is in their interest to do so, copyright owners can offer licenses at the statutory rate to some users and below the statutory rate to other users unwilling to pay the statutory rate.

5. My specific conclusions concerning the flaws in the work of Professor Teece and Ms. Guerin-Calvert, which I explain in further detail throughout the remainder of this report, are as follows:

a. To support his claims, Professor Teece assumes facts that are contradicted by the evidence.

(1) 

(2) Professor Teece is wrong that changes in the mechanical royalties have only a small effect on the Copyright Owners' income, because they also receive income from other sources.

(3) Professor Teece claims that music publishing is a "low-risk" business. However, songwriters are the principal recipients of mechanical royalties, and by Professor Teece's measure of risk, songwriting is not a low-risk business.

b. Professor Teece's proposals are inconsistent with the goal of the Copyright Act to increase the availability of creative works to the public.

c. Professor Teece incorrectly claims that the Copyright Owners' contributions to the creation and success of music are small.

d. Professor Teece misapplies both his Profiting from Technological Innovation model and his Dynamic Capabilities model to the issues in this proceeding.

e. Economic analysis does not support Professor Teece and Ms. Guerin-Calvert's arguments for converting the statutory rate from a penny rate to a percentage of revenue.

   (1) Professor Teece offers no evidence or economic analysis to support the claim that the Copyright Owners should bear more risk.

   (2) Professor Teece is wrong as a matter of economics that a percentage of revenue would better align the interests of the Copyright Owners and the record companies.

   (3) Neither Professor Teece nor Ms. Guerin-Calvert considers the effect of their proposed changes in the mechanical rate on the return to songwriting and the incentives of songwriters to create new music. Professor Teece incorrectly assumes that any change in the Copyright Owners' income from a reduction in mechanical royalties will be small because they earn income from other sources.

   (4) Professor Teece and Ms. Guerin-Calvert's proposed changes to the mechanical royalty can result in subsidizing

services that offer inferior products, causing both harm to Copyright Owners and waste of scarce resources.

(5) Neither Professor Teece nor Ms. Guerin-Calvert offers an economic basis on which to define the revenue base to which their proposed percentage of revenue royalty should be applied.

6. In sum, I conclude that Professor Teece and Ms. Guerin-Calvert's analyses and arguments for a reduced mechanical rate structured as a uniform percentage rate across multiple products and platforms are incorrect. Nothing in their reports leads me to change the conclusion I reached in my direct testimony that the Copyright Owners' rate proposal is reasonable and consistent with the factors in Section 801(b).

II. PROFESSOR TEECE'S ANALYSIS OF THE MUSIC PUBLISHING AND SONGWRITING INDUSTRIES

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8. Second, Professor Teece suggests that changes in the mechanical rate will have only a small effect on the copyright owners of musical compositions because they also receive performance royalties and synchronization and other income.[4] It is important to note,

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4 Teece Report at p. 62.

however, that songwriters receive a significantly larger share of mechanical royalties than do publishers. Because songwriters, not publishers, are most affected by the changes in the mechanical rate, I interpret Professor Teece's claim to extend to songwriters. I have examined songwriter income data under the current mechanical royalty rate. My analysis shows that songwriter incomes are modest and have been declining in real terms[5] since 2000 and that a large number of songwriters earn a significant fraction of their income from mechanical royalties. Therefore, a reduction in mechanical royalties likely will have a substantial impact on that income.

9. Third, Professor Teece claims that music publishing is a low risk business relative to the recorded music business. But again, Professor Teece ignores the level of risk faced by songwriters, the principal recipients of mechanical royalties. Using Professor Teece's own measure for risk, songwriting appears to be substantially riskier than distributing recorded music.

10. Fourth, Professor Teece claims that the music publishers contribute little to the creation and ultimate distribution of music. My review of publisher financial information, and in particular the level of advances they provide to songwriters, demonstrates that this claim is inaccurate.

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[5] Throughout this report, when I denote values in real terms, I use the "Consumer Price Index-Urban Wage Earners and Clerical Workers" (U.S. Bureau of Labor Statistics Series CWSR0000SA0) to convert nominal dollars to 2007 dollars. I do this because this is the Consumer Price Index ("CPI") that captures the broadest array of U.S. goods and services, and I conclude that it is an appropriate CPI to apply to the Copyright Owners' rate proposal.

11. Fifth, Professor Teece misapplies his theoretical framework to the issues at hand. Both his Profiting from Technological Innovation and Dynamic Capabilities models provide little insight into this case and do not support a decrease in mechanical rates that he advocates.

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B. Professor Teece Fails to Consider the Effect of the Statutory Mechanical Royalty Rate on Songwriters

14. Throughout his testimony, Professor Teece does not distinguish between music publishers and songwriters. Because songwriters rather than their publishers receive the larger fraction of mechanical and other royalty income, I have analyzed songwriter income received from both mechanical and other sources. This analysis shows that songwriter income has been declining and that a reduction in mechanical income would reduce further the earnings of a significant fraction of songwriters.

(1) Songwriter Mechanical Income and Total Royalty Income is Declining

15. My analysis examines the income earned during the period 2000 to 2006 by songwriters whose compositions are administered by Universal Music Publishing,[9] which I understand to be the largest publisher in the industry. Figures 2a and 2b show the average and the median[10] annual mechanical income, respectively, in 2007 dollars for 9,438 of this publisher's songwriters.[11] These figures show that these songwriters have seen a decline in the real value of their mechanical income from 2000 to 2006.

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[9] Although I attempted to analyze comparable data from other publishers, Universal Music Publishing was the only publisher that maintained information in a form that I could use for my analysis.

[10] The median 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.

[11] The data in all the figures in this section are based on the royalty income of a consistent set of songwriters with reported royalty earnings in every year during the period. I term this the "full songwriter sample."

16. Figures 3a and 3b present the same analysis, but for a sample of songwriters that excludes individuals in the "tails" of the songwriter income distribution. The sample in Figures 3a and 3b excludes 5,179 songwriters who on average earned less than $ (in 2007 dollars) per year over the seven-year period, and 95 songwriters who earned on average more than $ per year (in 2007 dollars) and thus were in the top one percent of all royalty earners for that period. Thus, these figures exclude a large number of songwriters with very low earnings and a small number of extremely successful songwriters. I did this in order to assess the effects, if any, on my analysis of (a) a small number of writers who earn an extremely large amount of royalties in any year and (b) the many songwriters who make a very small amount of money. I refer to this group, which includes 4,164 individual songwriters, as the "songwriter subgroup." Figures 3a and 3b reveal the same pattern of declining average and median mechanical royalties for the songwriter subgroup as Figures 2a and 2b do for all songwriters.

17. These data also contradict Professor Teece's suggestion that the effect of a change in the mechanical rate on songwriter income is likely to be small, because songwriters also receive performance royalties and synchronization and other income.[12] I examine this claim by analyzing the trend in overall royalty income received by Universal Music Publishing's songwriters. Figures 4a and 4b and Figures 5a and 5b report average and median total royalty income data for the full songwriter sample and the songwriter subgroup, respectively, over the period 2000 through 2006. These data show that, for both samples, average annual total royalty income in 2006 was approximately the same in real dollars as it was in 2000 and that in many of

[12] *See* Teece Report at p. 67.

the intervening years total royalty income was less than it was in 2000, while median income for both groups was substantially lower in 2006 than in 2000.

18. The data from Universal Music Publishing's songwriters further demonstrate that songwriting is, in general, not a high-earning occupation. Figure 6 provides data on the distribution of total royalties for the full songwriter sample and Figure 7 reports them for the songwriter subgroup. Both figures show that royalty payments are small on average and exhibit wide variation across songwriters. Indeed, both figures show that the vast majority of Universal Music Publishing's songwriters received $ or less in total royalties annually over the period from 2000 to 2006. Very few – less than 5 percent in the full songwriter sample and less than 7 percent in the songwriter subgroup – earned more than $ a year (in 2007 dollars) over the entire period.[13]

19. Thus, these data undermine Professor Teece's conclusion that the Copyright Owners' (and by extension, songwriters') total royalty earnings have increased (and will continue to increase) sufficiently to offset any reduction in mechanical royalties that will flow from a reduced statutory rate. By ignoring the effect of reducing the statutory mechanical rate on songwriters' incomes, Professor Teece ignores the corresponding effect on songwriters' incentives to create. As I explained in my direct testimony, failing to consider the incentive

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[13] Presumably, many of the individuals earning less than $10,000 per year supplement their songwriting income by devoting time and effort to non-songwriting activities. If mechanical rates were higher, economics predicts that some of these individuals would shift their time and effort to additional songwriting.

effects of a change in the statutory rate could reduce the amount of new music created in the long run and thereby reduce social welfare.

(2) Music Publisher Data Show that Large Numbers of Songwriters Depend on Mechanical Income

20. I next examine Professor Teece's claim that reducing the mechanical rate would have only a small effect on songwriter total income. I find that many songwriters depend heavily on mechanical royalty income and, therefore, reducing mechanical royalties would reduce their incomes. See Figures 8 and 9.

21. Figure 8 uses data for the full songwriter sample and shows the distribution of mechanical royalties as a share of total royalties. Figure 8 shows that a large fraction of songwriters depend on mechanical royalties for the bulk of their royalty income. Specifically, almost two thirds of the songwriters in the full songwriter sample receive one half or more of their royalty income from mechanical revenues, and almost 40 percent receive three quarters or more of their royalty income from mechanical revenues. Figure 9 shows a roughly similar distribution for the songwriter subgroup. In this group, approximately 55 percent of songwriters receive one half or more of their royalty income from mechanical royalties and 30 percent receive three quarters or more of their royalty income from mechanical revenues. The analyses set forth in these figures undermine Professor Teece's suggestion that songwriters' total royalty earnings have increased (and will continue to increase) sufficiently to offset any reduction in mechanical royalties that will flow from a reduced statutory rate.

C. Professor Teece's Analysis of the Relative Riskiness of the Recorded Music and Songwriting Industries

22. Professor Teece also argues that the statutory rate for mechanical licenses should be reduced to reflect the fact that music publishing is a "low-risk business," in contrast to

the greater risks faced by the recorded music industry. Analysis of the songwriter income data from Universal Music Publishing undermines Professor Teece's argument.

23. Professor Teece's analysis ignores the riskiness of songwriting. A music publisher's revenue reflects the return to a diversified portfolio of songs and songwriters, and it is a well known theorem of finance theory that a diversified portfolio of independent risks will be less risky than any individual component of that portfolio. However, the major part of the music publishers' royalty income after deducting the publishers' administration costs is paid to the individual songwriters – over 75 percent. And the risk faced by individual songwriters with respect to mechanical licensing revenue is substantially higher than the risk faced by music publishers alone.

24. Professor Teece relies on the "coefficient of variation"[14] in income as a measure of enterprise risk. The intuition for using the coefficient of variation to measure risk is clear. To illustrate, consider the following example. Assume that Party A earns $100 per year every year, while in any year Party B has a 50 percent probability of earning $200 but a 50 percent probability of earning nothing. Although Party B can expect on average to earn $100 per year, he may have long strings of years in which he earns nothing. Therefore, Party B's earnings are "riskier" than Party A's.

25. As evidence of the relative risk faced by the record companies, Professor Teece compares his estimate of the coefficient of variation of EMI's recorded music income over

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[14] The coefficient of variation is a statistical measure that compares the variation in values that a variable takes to its average value.

the period 1999 to 2006 to that of EMI's music publishing income over the same period.[15] Applying this method for estimating risk to the royalty income received by Universal Music Publishing's songwriters shows that they face substantially greater risk than the record companies. The average coefficient of variation for the royalty income of individual songwriters is more than 91 percent, or more than four times that of EMI's recorded music income, which Professor Teece found to be 21.9 percent. 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.

D. Professor Teece Understates the Contributions of Music Publishers

26. Professor Teece also claims as support for a reduction in mechanical royalties that music publishers do not make meaningful investments that contribute to the success of recordings. This claim is contradicted by data showing that music publishers make substantial financial investments in songwriters. I have examined the monetary advances that music publishers made to songwriters over the period 2001 to 2005. I find, for example, that Universal Music Publishing's annual advances between 2001 and 2005 averaged approximately [redacted] in 2007 dollars.[16] Similarly, EMI Music Publishing's average annual advances averaged almost [redacted] for the same five-year period.[17] And Warner/Chappell Music's

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[15] Teece Report at p. 68.

[16] *See* Universal Music Publishing Group Financial Reports (CO 9007805-9007936 at 9007815, 9007871; CO 9007668-9007803 at 9007681, 9007728; CO 9009185-9009335 at 9009200, 9009259; CO 9008866-9009011 at 9008887, 9008947; CO 9009013-9009183 at 9009034, 9009094).

[17] *See* EMI Music Publishing financial data (CO 4024775-4024794 at 4024786).

annual advances averaged approximately [redacted].[18] These advances reflect investments that publishers make in promoting and developing the careers of songwriters. Not only are the amounts that publishers advance to their songwriters large, but substantial amounts may remain unrecouped for long periods. Data provided by EMI Music Publishing show that of the more than [redacted] that EMI Music Publishing advanced to artists signed in 2002, more than [redacted] remained unrecouped as of 2006 and almost half of that, [redacted], was written off.[19]

E. Professor Teece's Analysis of the Relative Importance of Record Company and Songwriter Efforts to the Success of Recorded Songs

27. Professor Teece cites his Profiting From Technological Innovation ("PFI") framework as a basis for concluding that songwriters should receive little of the value created by their songs.[20] The PFI framework maintains that "firms that have capabilities and assets that the innovator [here, the songwriter] requires to convert the innovation [here, the song] into a successful product are likely to garner a greater share of the financial returns than is the innovator when the innovator is simply licensing its intellectual property ('IP') to others."[21]

28. Professor Teece has misinterpreted the implications of his PFI framework as it relates to the recorded music industry. If enough firms possess the relevant "capabilities and assets that the innovator requires to convert innovation into a successful product," they will

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[18] Warner/Chappell Music data.

[19] EMI Music Publishing data.

[20] *See* Teece Report at pp. 10-12.

[21] Teece Report at p. 10.

compete for the right "to convert the innovation into a successful product," and this competition will lead those firms to earn a competitive return while the innovator captures the principal share of profits.

29. Evidence that Professor Teece has misinterpreted his own theory as it relates to the recorded music industry is demonstrated by the fact that performers, as innovators whose creative works are not subject to compulsory licensing, capture a large share of the returns to their creations. Professor Teece's direct testimony discusses the substantial investments and efforts that the record companies make on behalf of their artists.[22] And there are undoubtedly many aspiring performers competing to be signed by record labels. Yet despite Professor Teece's opinion that the PFI framework predicts that "the firms that have capabilities and assets that the innovator [now, the artist] requires to convert the innovation [now, the performance] into a successful product are likely to garner a greater share of the financial returns than is the innovator when the innovator is simply licensing its intellectual property ('IP') to others," the RIAA's own data show that artists have historically received a large share of the revenues generated by record companies and continue to do so even in the face of the "paradigmatic shift" faced by the industry.[23] Thus, the market evidence from the recorded music business undermines

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[22] Teece Report at pp. 93-100.

[23] *See* RIAA 8423-8430 at 8423 (Copyright Owners' Trial Exhibit 41).

Professor Teece's conclusion that innovators should capture only a small part of the sums earned by recorded music.[24]

30. Moreover, the "innovation" at issue in this proceeding is not just a single song, but the body of all copyrighted songs. Without the value provided by music publishers in finding, developing and promoting songwriters, thereby putting together an accessible portfolio of songs available for recording, the costs to the record companies of seeking individual songs and negotiating with individual songwriters might substantially reduce the availability of songs they could economically record. Thus, Professor Teece's assertion that without record companies songwriters would make little money makes no more sense than the reverse claim that without copyrighted songs record companies would earn no money. Both record companies (and the artists they record) and music publishers (with their songwriters) jointly contribute to producing the product – recorded music that consumers value. Stated differently, songs and recordings are what economists term "complements in production." Each is better off because of the other, and there is no reason to conclude that the song is less important to a record's success than the performance and recording.[25]

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[24] Contrary to Professor Teece's PFI framework, we know from synch and ringtone licenses that, in the absence of a regulated rate, songwriters and music publishers capture large shares of licensing revenues.

[25] For example, RealNetworks download data show that for a given album by a given artist, some songs sell substantially more than others, even though the artist and record company are the same. Landes Report at p. 6, n. 3. If songs "didn't matter," we would observe all songs on a given album downloaded with equal frequency.

31. Similarly, as support for his conclusion that record companies will receive the bulk of the value of the copyrighted song, Professor Teece relies on his "Dynamic Capabilities" model. However, the relevance of the Dynamic Capabilities Model is unclear. As developed in Professor Teece's academic writings, the Dynamic Capabilities Model analyzes the factors that lead some firms within a single industry, such as a record company within the recording industry, to be more successful than its competitors. The theory does not address the division of surplus between firms in a vertical relationship, like music publishers and record companies, or between complementary inputs, such as recording artists and songwriters. "The dynamic capabilities approach seeks to provide a coherent (and evolutionary) framework for how firms develop competitive advantage, and maintain it over time."[26] It "endeavors to explain firm-level success and failure … [by] building a better theory of firm performance … ."[27] "Only recently have researchers begun to focus on the specifics of developing firm-specific capabilities and the manner in which competences are renewed to respond to shifts in the business environment. … [The Dynamic Capabilities Model] argues that the competitive advantage of firms stems from dynamic capabilities rooted in high performance routines operating inside the firm, embedded in the firm's processes, and conditioned by its history. It offers dynamic capabilities as an emerging paradigm of the modern business firm … ."[28] In plain language, the

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[26] Augier and Teece, "Dynamic Capabilities and Multinational Enterprise," 47 *Management International Review* 2 (2007), 175-192, at p. 179.

[27] Teece, Pisano and Shuen, "Dynamic Capabilities and Strategic Management," 18 *Strategic Management Journal* 7 (1997), 509-533, at p. 509.

[28] Teece and Pisano, "The Dynamic Capabilities of Firms: An Introduction," 3 *Industrial and Corporate Change* 3 (1994), 537-556, at p. 537.

Dynamic Capabilities Model argues that firms with better managerial strategies that let them respond more efficiently to changes in the business environment will fare better than their rivals.

III. MS. GUERIN-CALVERT'S ARGUMENTS IN SUPPORT OF AN APPROXIMATE 4 PERCENT STATUTORY RATE FOR DIGITAL SERVICES

32. Ms. Guerin-Calvert's argument for an approximately 4 percent statutory mechanical rate for digital music services depends on her claim that DiMA members need a modest statutory rate to assure the survival of nascent and innovative forms of digital music delivery. However, economics does not provide a basis for setting the statutory rate at a low level in order to promote the success of *any* proposed business model for music delivery. Nor is there an economic justification for promoting a business model that depends for its long-term viability on the continuation of a discount. To the contrary, subsidizing inefficient firms or low value products at the expense of more efficient firms or higher value products simply wastes scarce resources.

33. Moreover, these new business models for delivery of recorded music, for which Ms. Guerin-Calvert requests subsidies, are substitutable for other established models as well as for one another. Because the different models of music delivery all compete with each other for the same consumer expenditures, requiring the Copyright Owners to subsidize some business models relative to others will result in the subsidized business models expanding at the expense of those that offer higher payments to the copyright owners. As a result, copyright owners will be injured. Consequently, it is more appropriate from an economic standpoint to provide a common framework for licensing mechanical rights based on the value of the underlying music. I discuss this further in the next section.

IV. PROFESSOR TEECE AND MS. GUERIN-CALVERT'S ARGUMENTS FAVORING A PERCENTAGE RATE OVER A PENNY RATE

34. In addition to arguing for a lower statutory rate, both Professor Teece and Ms. Guerin-Calvert propose changing the structure of the royalty from a penny rate to a percentage of revenue. First, Professor Teece claims that such a royalty structure is economically beneficial because it would cause publishers and songwriters to bear an increased share of the risk faced by the record companies from the changing business models for delivering music and piracy. Second, Professor Teece claims that a percentage rate would "better align" the interests of the record companies and the publishers than a per-unit royalty does and, therefore, would benefit both parties. Third, both Professor Teece and Ms. Guerin-Calvert argue that a royalty based on a percentage of revenue is needed to provide "flexibility" in the face of new and nascent business models. I believe that in all three instances the economic reasoning that Professor Teece and Ms. Guerin-Calvert offer for the advantages of a percentage royalty is either incorrect as a matter of theory or contradicted by the evidence.

35. Professor Teece offers no economic rationale for why songwriters and publishers should bear an increased share of the risk in the recorded music industry. Although there has been a decline in record companies' revenues between 2000 and 2005, that decline was due principally to a decline in unit sales; wholesale prices declined slightly between 2000 and 2005,[29] and this decline in wholesale prices could well reflect reductions in record companies' costs. At the same time, the RIAA's data show that the four major record companies earned profits during the five-year period 2001 to 2005 that were substantially higher than the profits

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[29] Teece Report at p. 27, Exhibit 11.

they earned during the five preceding years, despite the decline in CD sales.[30] Under a penny rate, the decline in unit sales imposes the same proportionate reduction in income on the Copyright Owners as on the record companies. As a result, songwriters and publishers already bear substantial losses from declining sales, because lost sales (whether due to piracy or otherwise) return no mechanical royalties to the publisher or the songwriter.

36. Economics would justify shifting additional risk to songwriters and publishers for three reasons, none of which is present here. If songwriters and/or publishers had a greater preference for risk than the record companies did, then both could be made better off by shifting some of that risk. Professor Teece has provided no evidence that this is the case. Second, if one party is better at avoiding losses than another, shifting the burden of loss to the "lower cost avoider" can result in an overall reduction in expected losses. If, for instance, songwriters and publishers were more effective than the record companies in reducing the losses from piracy, shifting the risk of these losses to them could reduce piracy overall by providing added incentives to the most efficient loss avoider to undertake measures that reduce the probability and magnitude of piracy. However, Professor Teece offers no analysis or evidence that indicates songwriters are more efficient risk avoiders than are the record companies.

37. Third, economics also supports shifting a greater burden of the risk to a party if that party is better able to diversify that risk than are others. Again, Professor Teece offers no analysis or evidence to support a conclusion that publishers and songwriters are better able to diversify risk than are the record companies. In addition, a percentage royalty would

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[30] *See* RIAA 8423-8430 at 8423 (Copyright Owners' Trial Exhibit 41).

mean that songwriters and publishers would face risks from sources other than piracy, such as inefficient behavior by the record companies that lowers prices. Songwriters and publishers do not control the quality of the other inputs or the final price of the recording. Therefore, under a percentage royalty, songwriters and publishers' incomes could fall as a result of record companies' decisions to reduce quality and/or give away or cut prices of records in exchange for other considerations.

38. Professor Teece is also wrong that a royalty based on a percentage of revenue better aligns the interests of songwriters and publishers with the interests of the record companies and therefore can benefit both parties. First, if that were the case one would have expected a percentage royalty to have arisen as a result of negotiation between the parties over time. The compulsory license is invoked only when the parties cannot agree on a royalty, and the Copyright Act does not prevent parties from negotiating a royalty in any form to which they agree. Nonetheless, the Copyright Owners and the recorded music industry negotiated industry-wide agreements in 1987 and 1997 on a penny rate basis.

39. Moreover, the arguments that Professor Teece offers for the "mutual benefits" to be gained from a percentage royalty also apply to record companies' revenues from licensing their music to digital music providers, such as iTunes. My review of the contracts that the major record companies have negotiated with iTunes, however, reveals that the record companies are compensated on either a fixed fee basis or a percentage of retail revenue with a fixed fee minimum. Similarly, although the record companies' licenses for recordings to subscription services commonly contain percent-of-revenue tiers, these agreements virtually always contain per-play minimum penny rates.

40. Finally, Professor Teece's claim that a royalty based on a percentage of revenue better aligns the incentives of the two parties is not correct as a matter of theory. 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.[31] Consider, for example, a product that commands a price of $100 and costs $95 to produce. Assume further that the producer pays a fixed royalty of $4.00, so that its final profit is $1.00 per unit. If the producer could adopt an innovation that raised the quality of the product and increased the price by $10.00 at a cost of $9.75 it would do so, because its profit would increase by $0.25 per unit (from $1.00 to $1.25 per unit, a 25 percent increase in profitability). However, if the producer had to pay a royalty of 4 percent of revenue, it would not undertake the innovation, because the resulting increase in royalty of $0.40 per unit would exceed $0.25, yielding a profit of only $0.85 compared to the pre-innovation profit of $1.00. In general, a royalty based on a percentage of revenue would reduce the record companies' incentives to combat piracy and/or invest in improving the quality of recordings, since they would receive less than the full value of the gains caused by their investments.

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[31] Professor Teece acknowledges this point in footnote 79 on page 71 of his report. He argues, however, that the effect would likely be small because of the "relatively high fixed cost associated with creating and releasing a recording relative to the marginal cost of delivering additional unit sales." Although the effect may be small, it nevertheless would result in a divergence between the interests of the songwriters and the record companies.

41. Ms. Guerin-Calvert argues in support of a percentage of revenue structure that "an economic perspective entails recognition of the fact that in developing industries and technologies with a variety of business models and strategies, the methodology must be such so as not to favor particular technologies nor substantially disadvantage others."[32] (Professor Teece similarly supports his analysis by pointing to the developing nature of the digital music business.) While I agree that the royalty structure should not favor particular technologies, I think this goal is not advanced by a percentage of revenue royalty when, as in this case, the royalty rate serves as a ceiling on the rates available to copyright owners. Such a royalty can serve as a subsidy to firms and business models that are not successful in generating consumer acceptance, either because they are inefficient or because they produce an inferior product. And, as I have already explained, because the different models of music delivery all compete with each other for the same consumer expenditures, requiring the copyright owners to subsidize some business models relative to others will increase their injury beyond simply forcing them to take a lower rate. First, the availability of the compulsory license means that copyright holders of music would have to license their compositions to some services at lowered rates, and second, these lowered rates make it more likely that the subsidized services will take business from those other delivery methods that pay higher rates.

42. Moreover, as I have already noted, 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. Therefore, in the

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[32] Guerin-Calvert Report at p. 11.

event that the publishers and songwriters believe they would benefit from encouraging the success of a particular online digital delivery business model, a lower rate could be achieved through voluntary negotiation.

43. I also believe that imposing a percentage of revenue royalty is at odds with the objective of section 801(b) to minimize the disruptive impact of the royalty on the structure of the industry and prevailing industry practices. Because a per-unit structure for the royalty has been the prevailing structure for physical records and digital downloads, maintaining the prevailing model for these forms of music delivery is not disruptive. With respect to limited download and interactive streaming services, the proposal of the Copyright Owners follows the structure of the agreements between the record companies and the subscription services. As a result, the Copyright Owners' proposal does not add to the subscription services' costs of collecting and maintaining data in order to ensure accurate payments beyond the data they have to collect and maintain in order to satisfy their obligations under their agreements with the record companies. Similarly, the Copyright Owners' proposal for a percentage of revenue rate for ringtones follows the structure of royalties that were established in the market prior to the determination by the Register of Copyrights that ringtones fell within the scope of the compulsory license. As a result, the Copyright Owners' proposals impose no disruptive costs on either the record companies or the digital delivery services.

44. Ms. Guerin-Calvert also argues that the percentage rate royalty structure should not be subject to any minimum payment to the Copyright Owners for the use of their compositions because such a minimum would be inconsistent with the further development of the digital music industry. But her arguments against a minimum are inconsistent with the market agreements that the digital music services have entered into with the record companies.

These voluntarily negotiated agreements routinely provide for minimum payments per use of each song to record companies. If, as Ms. Guerin-Calvert claims, these new and nascent business models could not succeed if minimum payments were imposed on them, the record companies' agreements would reflect that fact. Moreover, there is no evidence that the minimum payments demanded by the record companies have inhibited the development of the digital music services.

45. Finally, Ms. Guerin-Calvert seeks to apply a percentage of revenue rate to an artificially small revenue base. As I understand, she claims that the royalty should apply only to direct payments for music,[33] so that if, for example, producers of MP3 players were to preload their devices with music, the copyright owners might receive no mechanical royalties. Since the users of preloaded MP3 players value both the sound recordings and the copyrighted songs, there is no economic rationale for denying the Copyright Owners compensation for the use of their music simply because users of that music are able to convert the revenue they receive from "direct payments" to indirect payment as part of a bundle.

46. Indeed, Ms. Guerin-Calvert's testimony highlights one of the major problems with using a revenue-based rather than unit-based royalty, and that is the possibility that reported revenue can be manipulated in order to reduce the royalties that copyright holders receive for their music. Under a revenue-based system, for example, users of music could barter their music services in exchange for revenue from advertising or the sale of ancillary products without compensating copyright owners. Under a unit-based royalty, like the penny rate, the

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[33] *See generally* 2/25/08 Tr. at 4484:19 – 4500:13 (Guerin-Calvert).

music copyright owners would be assured of the same compensation without regard to how the user of the music generated revenue. On the other hand, a pure percentage rate may be difficult to apply to many of the business models under consideration in the digital music market. This concern is not merely hypothetical. In the last few weeks, Apple announced that it is contemplating offering customers free access to its iTunes library in exchange for a premium price for iPods and iPhones,[34] and Warner Music Group is reportedly promoting a plan to bundle a monthly fee for unlimited access to digital music into bills for internet service.[35] Neither Professor Teece nor Ms. Guerin-Calvert adequately addresses the difficulties these business models pose for the application of a percentage rate, particularly one that does not guarantee adequate minimum royalty payments to the Copyright Owners.

47. Indeed, neither Professor Teece nor Ms. Guerin-Calvert considers the complexities of how to define "revenue" for the purposes of this proceeding. Ms. Guerin-Calvert puts forward a very narrow definition, which, she wrote, "should capture actual revenues from the sale of music subject to Section 115" and "should meet the principles that it allows for different sources of revenue, but should not be so broad as to encompass adjacent but not directly related business or revenue sources."[36] She does not address how this definition of revenue could be manipulated by a business that uses the sale of music as a loss-leader for other products,

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[34] "Apple mulls unlimited music bundle," FT.com, March 18, 2008, *available at* http://www.ft.com/cms/s/0/b55a0d64-f523-11dc-a21b-000077b07658.html?nclick_check=1.

[35] "Fee for All," Portfolio.com, March 27, 2008, *available at* http://www.portfolio.com/news-markets/top-5/2008/03/27/Warners-New-Web-Guru.

[36] Guerin-Calvert Report at p. 7. *See also* 2/25/08 Tr. at 4484:19 – 4500:13 (Guerin-Calvert).

to generate advertising revenue that could not be directly tied to music, or as a draw to sell other merchandise. Professor Teece declined to define revenue at all.[37]

48. I have reviewed the Copyright Owners' proposed definition of "revenue" – which would be used for their rate proposals for limited downloads, interactive streaming, and ringtones – and find it to be reasonable in the following sense. Although the Copyright Owners' definition may not address every conceivable issue that could arise, it has the advantage of being broader than the definition put forward by Ms. Guerin-Calvert and will more likely capture revenues that are generated by embodying the Copyright Owners' compositions than Ms. Guerin-Calvert's definition. In particular, the Copyright Owners' definition allows them to capture revenue attributable to music when it is not separately charged for but bundled with another service or product.

V. THE ANALYSIS IN MY WRITTEN DIRECT TESTIMONY REMAINS ACCURATE

49. A number of questions have been raised about various aspects of the analysis in my direct testimony. Here I first briefly review my analysis of the statutory mechanical rate and the appropriate approach to rate-setting in light of Section 115 and Section 801(b) of the Copyright Act. I then explain why, notwithstanding the suggestions of the RIAA during the direct hearing, the rates paid for licenses to musical compositions used in mastertones and synchronization licenses are an appropriate benchmark for setting the mechanical statutory rate. I also respond to questions that were raised at trial concerning the exclusion from my

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[37] *See* 2/19/08 Tr. at 3698:21 – 3701:1 (Teece).

analysis of HFA licensing data of licenses issued for compositions subject to controlled composition clauses and demonstrate that the inclusion of these data do not affect the conclusion I reached in my written direct testimony. Finally, I respond to questions that were raised at trial as to why one does not observe licensing activity in the HFA data above the statutory rate and why rates for the first use of compositions do not provide a reliable benchmark for the statutory rate.

A. Overview of My Direct Testimony

50. In my direct testimony, I concluded that the Copyright Owners' proposed set of statutory mechanical rates for 2008 through 2012 was reasonable from an economic perspective. Below, I briefly summarize my economic reasoning and explain why nothing in the testimony of Professor Teece and Ms. Guerin-Calvert alters my initial conclusion.

51. I first established a range of reasonable benchmarks for evaluating the Copyright Owners' proposed set of statutory mechanical rates. This range was based on voluntary transactions unconstrained by compulsory licensing that divided the total value of the music content pool between the record companies (the owners of the copyrights in the recordings) and the copyright owners (the owners of the copyrights in the musical compositions).

52. In my testimony, I stressed that it is the relative, not absolute, values of the content pool that matter in these benchmarks. That is, the benchmarks focus on how users value the copyrighted song relative to the sound recording in the market, not the absolute amounts paid for these licenses. I also explained why 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. I analyzed voluntary transactions where, as is the case for the uses of music in this proceeding, the user requires a license for both the copyrighted song and

the sound recording. Specifically, I examined the voluntary division between the copyright owners of musical compositions and the record companies of the total music content pool – the sum that the user pays for the right to use the song and the sound recording – in the markets for synchronization rights and for ringtones. These voluntary divisions reveal a benchmark for the relative values of the song and the sound recording. I also considered the relative division of compensation for copyrighted songs and for sound recordings that is embodied in the Audio Home Recording Act ("AHRA"). Although the division reflected in 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. In sum, voluntary transactions in the synchronization and ringtone markets and in the outcome of the AHRA yield a range of reasonable benchmarks for the copyright owners' share of the value of the music content pool in this proceeding of between 20 and 50 percent.

53. I then analyzed the implications of the Copyright Owners' proposed set of statutory mechanical rates for 2008 through 2012 for the division of the total value of the content pool relevant to this proceeding between the record companies and the copyright owners of musical compositions. I found that the proposed rates fell well within, and indeed at the low end of, the range of reasonableness established by voluntary transactions. I also found the proposed rates to be consistent with the first three objectives of Section 801(b) because those objectives imply that the rates should be benchmarked against free market transactions.

54. I also concluded that the Copyright Owners' proposed rates were consistent with the fourth Section 801(b) objective, which is to minimize disruption. From an economic standpoint, disruption involves expenditures of real resource costs, such as the need to

procure new computer hardware and/or software or the need to establish new accounting procedures, in order to implement the new rate proposals.[38] The Copyright Owners' proposal for physical records and for digital downloads continues the long-established penny rate structure for which both the record companies and copyright owners have institutional and accounting procedures in place. Therefore, the proposal imposes no new burden on the parties requiring them to devote real resources to establishing new procedures. And the structures of the Copyright Owners' proposed rates for limited downloads, interactive streaming and ringtones follow closely the structure of the agreements that the record companies themselves have with these services and therefore impose no additional requirements on the copyright users for accounting procedures or data capture beyond those they must already maintain in order to ensure their own accurate payment.

55. Further, if the CRJs set a compulsory rate that turns out to be too high for some users, I would expect the parties to negotiate rates below the statutory rate and to incur transactions costs in the process. Moreover, for reasons I explained in my direct testimony, I also expect the transactions cost of any such negotiation to be relatively low. However, I recognize that the higher the compulsory rate is set within the range of reasonableness established by my analysis, the greater the likely number of such negotiations and the greater the increase in total transactions costs. For this reason, setting a statutory rate at the high end of the

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[38] Indeed, this is consistent with the view that the CRJs took in the SDARS proceeding. *See* Final Determination of Rates and Terms, *In the Matter of Determination of Rates and Terms for Preexisting Subscription Services and Satellite Digital Audio Radio Services*, Docket No. 2006-1 CRB DSTRA, at p. 66 (noting that a rate is "disruptive . . . if it directly produces an adverse impact that is substantial, immediate and irreversible in the short-run").

range of reasonableness would increase the resource (disruption) costs devoted to negotiation, which have to be balanced against the gain from the enhanced incentives to create new music that would result from setting a high rate.

B. My Benchmarks are Appropriate Comparables

56. Questions also were raised about whether the market benchmarks on which I rely are sufficiently comparable to be utilized in determining a reasonable royalty rate in this proceeding. For the reasons I explain below, I continue to believe that my benchmarks set an appropriate range for assessing the reasonableness of the Copyright Owners' proposed mechanical rates and that those rates are reasonable because they fall within that range.

57. The principal basis for these questions appears not to be that the rights at issue in my benchmarks – synch rights, the rights covered by the AHRA, and ringtones – differ fundamentally from mechanical rights, but that the benchmark division of the music content pool between the Copyright Owners and the record companies is determined by unique conditions in those markets. For example, the RIAA has suggested that the 50/50 division of payments between the master recording and the composition for synch rights is not a reliable benchmark for mechanical rights, because the synch rights users can always choose to record their own cover version of a song rather than use a record company's master recording.[39] First, however, just as the original recording faces competition, so does the song. Few songs are so unique that a commercial or movie can use only that song to convey a particular message. Second, I am unaware of any empirical data that licensees of synch rights prefer to record a cover version

[39] 2/11/08 Tr. at 2456:2 – 2458:3 (Landes).

rather than use an existing master recording. Indeed, in many cases consumers' familiarity with the original master recording presumably makes using the original more valuable than a new recording. Finally, recording a cover version is in itself a costly enterprise.

58. The RIAA also questions my use of the division of the music content pool established by the AHRA as a benchmark, since, they suggest, this division is the result of legislation and not voluntary agreement.[40] In my direct testimony, I acknowledged this difficulty with the AHRA benchmark, but said that it nevertheless was the result of a negotiated compromise between different interest groups. Subsequent to the filing of my amended direct testimony, I became aware of an article[41] that discussed the then-pending legislation and explained that the rights holders affected by the legislation had reached a voluntary agreement with respect to the division of the funds to be collected. According to this article, Congress then incorporated that voluntary division into the legislation it enacted.

59. The RIAA also questions whether the mastertone rates on which I rely in my analysis provide an appropriate comparable for mechanical royalty rates. The argument appears to be that the markets are different because ringtones are created only from hit songs.[42]

60. The data that I have seen show that the demand for ringtones is not limited to a few hit songs. For example, almost ███ Universal Music Publishing songs earned

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[40] *See* 2/11/08 Tr. at 2461:5 – 2462:3 (Landes); Transcript of the Deposition of William M. Landes, dated 10/2/07 ("Landes Dep. Tr."), at 49:5 – 51:8.

[41] This article is attached as Exhibit C ("The DAT Pact," *Popular Electronics*, November 1991).

[42] *See* 2/5/08 Tr. at 1694:5 – 1699:5 (Peer).

mastertone revenue in 2006, and almost [redacted] earned mastertone revenue in 2007.[43] Data from EMI similarly indicate a broad market for ringtones; almost [redacted] EMI songs earned ringtone royalties in 2006, representing almost [redacted] percent of the EMI songs that earned any royalties in 2006.[44]

61. The decision by the CRJs in the SDARS proceeding provides further support for the reasonableness of the benchmark range of 20 to 50 percent for the Copyright Owners' share of the musical content pool. In that proceeding, the CRJs awarded the record companies performance royalties of 6 percent of satellite radio revenue.[45] The tribunal reached that conclusion on rates with the understanding that the performing rights societies in the aggregate receive 2.35 percent of SDARS revenue.[46] This implies a value for the Copyright Owners' share of SDARS revenue relative to the record companies of 28 percent of the music content pool, which is consistent with the benchmark range that I have concluded to be reasonable.

C. An Expanded Analysis of the HFA Licensing Data Continues to Support a Statutory Rate Increase

62. As part of my direct testimony, I provided data on the number of licenses issued by HFA at or below the statutory rate from 1996 to 2005. These data showed a general

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43 Universal Music Publishing data.

44 EMI Music Publishing data.

45 *See* Final Determination of Rates and Terms, *In the Matter of Determination of Rates and Terms for Preexisting Subscription Services and Satellite Digital Audio Radio Services*, Docket No. 2006-1 CRB DSTRA, at p. 70.

46 *See id.* at p. 34.

decline in the number of licenses issued below the statutory rate over the time period I examined. Based on my analysis of this data, I concluded that the value of musical compositions had been increasing and that the statutory rate was increasingly acting as a ceiling on the mechanical licensing rates that could be negotiated in a market unconstrained by the statutory rate. In my opinion, these data showed that the current statutory rate was too low and an increase in the rate would be reasonable.

63. Over the course of the proceeding, it has been suggested that my analysis of HFA licensing data for physical products may be sensitive to the exclusion of licenses issued to compositions that were subject to controlled composition clauses.[47] In order to address this concern, I have examined whether the inclusion of licenses that were subject to a controlled composition clause made any difference in my analysis. Figures 10 and 11 show the results of this updated analysis. Figure 10 shows the percentage of HFA licenses issued at the statutory rate in each year, as well as at various fractions of the statutory rate, and Figure 11 weights each of these licenses by the volume of units sold pursuant to the license in each year. The data presented in these figures show the same pattern as the figures in my original testimony: whether or not licenses for compositions subject to controlled composition clauses are included, the fraction of HFA licenses issued at less than the full statutory rate has declined. Thus, these data continue to show that the statutory license rate has increasingly become too low relative to the value of mechanical rights and support the reasonableness of an increase in the rate.

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[47] *See* 2/7/08 Tr. at 2160:11-19 (Landes); 2/11/08 Tr. at 2308:18 – 2310:5 (Landes); Landes Dep. Tr. at 94:5 – 96:6.

D. My Exclusion of Licenses Issued Pursuant to Controlled Composition Clauses Was Correct

64. Figures 10 and 11 show that the decline in the number of licenses issued below the statutory rate is evident even when licenses for compositions subject to controlled composition clauses are included. Notwithstanding this fact, I believe that I was correct to exclude licenses for such compositions from my analysis in the first place. More important, I believe that it would be incorrect to use the rates from licenses for compositions subject to controlled composition clauses as a benchmark in this proceeding.

65. First, a controlled composition clause is typically just a single component of an artist contract – a complicated, multi-part agreement between an artist and a record company that governs many types of rights. I reviewed a sample of singer-songwriter contracts produced by the record companies during discovery.[48] These lengthy contracts contain provisions that govern (among other things) artist royalties, advances, payments of recording costs, rights for creative and marketing materials, and payments for album packaging materials, in addition to licenses for musical compositions included on the artist's albums. From 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. If the parties to the agreement value some components of the agreement differently, both can be made better off by trading off among the various terms. For example, Party A may be willing to offer a concession on Issue X

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[48] These agreements include those contained in Exhibits COA 5-8 to my amended written direct statement, as well as the agreements Bates-stamped RIAA 45349-45401, RIAA 45261-45313, RIAA 17380-17487, and RIAA 17546-17610.

in exchange for better terms from Party B on Issue Y, and Party B may value the concession on Issue X more highly than the improvement in terms on Issue Y that Party A wants in exchange for that concession. In short, focusing only on Issue X in a multi-part agreement can yield misleading information because the terms covering X are not independent of the terms governing Y and other parts of the agreement.

66. There are circumstances, however, when one may rely on the individual terms of multi-part agreements. A good example of this is the mastertone rates in the New Digital Media Agreements ("NDMAs") between record companies and music publishers, which include licenses for copyrighted songs in dual disc products, video clips and locked content. I used the NDMA mastertone agreements as a voluntary benchmark in my written direct testimony based on the relative valuation of rights acquired by licensees in order to sell mastertones.[49] Witnesses for the RIAA have suggested that it was inappropriate for me to do so.[50] However, I disagree.

67. Although the mastertone licenses arose in the context of a multi-issue contract, the rates are consistent with both earlier and contemporaneous voluntary ringtone agreements between music publishers and third-party ringtone providers, on the one hand, and record companies and third-party ringtone providers, on the other. By comparing the relative

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[49] These agreements are contained in Exhibits CO 219-221 to the Written Direct Testimony of Roger Faxon; Exhibit CO 332 to the Written Direct Testimony of Nicholas Firth; and Exhibits COA 93-95, 123-124, 199 and 202-206 to my amended written direct testimony.

[50] *See, e.g.*, Written Direct Testimony of Ron Wilcox at pp. 23-30; Written Direct Testimony of Andrea Finkelstein at pp. 12-13.

valuations for the song and the recording reflected in the NDMAs to those reflected in these licenses, I find that the relative valuations revealed in the NDMAs are unaffected by terms for the other rights covered by the agreements, and therefore they can be used as a benchmark on a stand-alone basis. If instead, 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 stand-alone agreements. That the NDMA terms are substantially similar to those contained in the earlier standalone agreements undermines the record companies' assertion that the NDMA mastertone rate represents a premium to which they agreed in order to obtain the other rights that were granted.

E. The Absence of Bargaining Above the Statutory Rate Does Not Undercut My Analysis of the HFA Licensing Data

68. Questions were raised by the RIAA, DiMA and the CRJs about the absence of HFA licenses at rates above the statutory rate, given that licensing through HFA instead of using the statutory scheme affords cost savings to the record companies.[51] I have given some additional thought to this question since offering my original testimony.

69. There is a simple economic reason why it is not in the publishers' interests to charge licensees rates, either directly or through HFA, above the statutory rate. The cost savings that HFA makes possible are on a transaction basis, not on a "per-copy" basis. That is,

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[51] *See* 2/7/08 Tr. at 2118:17 – 2119:15 (Landes); 2/11/08 Tr. at 2566:5 – 2567:9 (Landes); Landes Dep. Tr. at 75:5 – 76:21.

the cost savings from bypassing the Copyright Office is primarily per license, not per copy. Therefore, one would not expect to see either a publisher or HFA charge a per-copy license fee in excess of 9.1 cents. Put differently, the statutory rate still functions as a ceiling on the per-copy mechanical licensing fee.[52]

70. In addition, by offering the record companies a lower cost alternative to the compulsory process, direct licensing and licensing through HFA expands the demand for licenses (i.e., increases the number of licenses that record companies will seek at every possible royalty rate) and thereby benefits songwriters and publishers. The publishers also derive benefits from using HFA as a licensing clearinghouse. For example, HFA provides publishers with monitoring functions, such as audits of record companies, that would be more costly if each publisher had to undertake these tasks independently. Because the publishers benefit directly from the efficiencies that HFA creates, it is in their self-interest to offer licensees an alternative to the compulsory process even if they do not pass on any of the cost.

71. Finally, the record companies and the music publishers treat the statutory rate as an effective ceiling, as did the CRT in 1980.[53] The fact that the statutory rate operates as an effective ceiling on the amount that copyright owners can charge has important implications

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[52] This still leaves open the question why licensees do not pay some type of upfront or per-license charge. I understand, however, that HFA recently has begun to charge some licensees an administration fee.

[53] *See, e.g.*, Adjustment of Royalty Payable Under Compulsory License for Making and Distributing Phonorecords (C.R.T. 1981), 46 Fed. Reg. 10466 at 10482 (stating that record companies "exploit the statutory rate payable under a compulsory license to keep their mechanical royalty costs as low as possible, fixing the 2 cent royalty as a ceiling in all negotiations with copyright owners, even for first releases").

for rate-setting in this proceeding. Although parties are free to bargain below the statutory rate, 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.[54] Thus, an important economic consideration in this proceeding should be to avoid setting a rate that is too low – capping the remuneration available to copyright owners and resulting in an effective transfer of wealth from the copyright owners to the copyright users and a reduced incentive to create music – rather than setting a rate that is too high.

F. Rates for "First Use" Licenses Do Not Undercut My Analysis of the HFA Licensing Data

72. I was also asked in the direct phase of this proceeding why I did not consider rates negotiated for licenses for the first use of songs as a benchmark for the statutory rate, since first use is not subject to the compulsory license.[55] I have given additional thought to this question and continue to believe that the price paid for first use is not an appropriate benchmark for setting the statutory rate.

73. First, I understand that the vast majority of first-use licenses today are typically included in complex artist contracts that also contain controlled composition clauses. As I explained earlier, extracting individual terms contained in multi-term agreements can be

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[54] Andrea Finkelstein, an employee of Sony BMG and a witness for the RIAA, acknowledged as much during her oral testimony. In response to a question about what her company would do if publishers asked for a mechanical rate above the statutory rate, she acknowledged "we would go compulsory if we had to." 2/14/08 Tr. at 3382:13-14 (A. Finkelstein).

[55] *See* 2/11/08 Tr. at 2315:19 – 2317:4, 2384:8 – 2389:2 (Landes); *see also* Landes Dep. Tr. at 76:22 – 79:5.

misleading from an economic standpoint and, therefore, relying on controlled composition rates, in particular, poses a number of difficulties. Any such license is therefore not reliable as a benchmark.

74. Second, because new songs compete to be recorded with old songs, first-use rates are constrained by the mechanical rates paid for old songs. When a copyright owner promotes the first use of a song, that owner necessarily faces constraints on the rate it can charge from the large number of substitutes in the form of preexisting songs available to potential licensees at rates at or below the statutory rate through mechanical licenses. As 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.

75. In addition, I previously referred to a "selection bias" problem in the first use of songs.[56] Because first-use licenses (by definition) concern new and unrecorded songs, licensees have little market-based knowledge about how well a first-use song will perform. This situation differs from the one that exists for songs that have previously been recorded and tested in the market, where a licensee can tell a pre-existing "good" song from simply an average one based on how the songs have performed in the market. With little market-based information for a song being licensed for its first use, licensees would be unlikely to gamble (in the form of a higher license rate) on the likely success of a new musical composition.

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[56] *See* 2/11/08 Tr. at 2388:7-20 (Landes).

76. Finally, first-use licenses cannot be understood apart from the expected flow of future licensing revenues they make possible. That is, there must be a first use before a song can be available for future recording and the associated mechanical royalties. Thus, the first-use license is a "ticket" not only to licensing income under the instant agreement, but also to a stream of future income. Consequently, a songwriter might be willing to charge very little for, or even give away, the first use in order to gain the prospect of future income from subsequent users. For these reasons, I believe it is inappropriate to consider first use rates in isolation as a benchmark for what the mechanical rate would be in the absence of the compulsory license.

VI. CONCLUSION

77. In sum, I conclude that Professor Teece and Ms. Guerin-Calvert's proposals for reducing the statutory rate and changing its structure from a per-unit fee to a uniform percent of revenue are not reasonable. Nothing in their reports leads me to change the conclusion I reached in my direct testimony that the Copyright Owners' rate proposal is reasonable and consistent with the factors in Section 801(b).

78. As I have explained in this report, neither Professor Teece nor Ms. Guerin-Calvert presents a sound economic basis for their proposals. Professor Teece's conclusions are based on assumptions that are contradicted by facts. [redacted] Professor Teece claims that changes in the mechanical royalties have only a small effect on the Copyright Owners' income. My analysis in Section II.B demonstrates that this claim also is incorrect. In Sections II.C and II.D, I show that

Professor Teece understates both the riskiness of songwriting and the importance of the Copyright Owners' contributions to the development and success of new music.

79. Professor Teece and Ms. Guerin-Calvert's arguments for converting the statutory rate from a penny rate to a percentage of revenue also have no economic support. As I show in Section III, Ms. Guerin-Calvert's proposed changes to the mechanical royalty could result in subsidizing services that offer inferior products, which will harm Copyright Owners and waste the economy's scarce resources. In Section IV, I show that Professor Teece's claim that a percentage of revenue structure is beneficial because it would (1) shift more risk to the Copyright Owners and (2) better align the interests of the Copyright Owners and the record companies has no economic support. And neither Professor Teece nor Ms. Guerin-Calvert provides an economic basis on which to define the revenue base to which their proposed percentage of revenue royalty would apply.

80. Neither Professor Teece nor Ms. Guerin-Calvert considers the likely harmful economic effects of the rates and rate structure they advocate. Their proposals conflict with the underlying objectives of Section 801(b) of the Copyright Act – to provide incentives to create and distribute new music. The rates Professor Teece and Ms. Guerin-Calvert propose would reduce the return to songwriting and, therefore, reduce the time and effort composers devote to creating new songs. As a result, fewer songs would be created, 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.

81. Finally, I respond to questions raised with respect to the economic reasoning on which I based my conclusion that the Copyright Owners' rate proposal is reasonable and consistent with the factors in Section 801(b). I show that my initial analysis of

HFA data was not sensitive to the exclusion of licenses issued for compositions subject to controlled composition clauses. I explain why my original exclusion of such licenses was appropriate. I also explain why the absence of bargaining above the statutory rate, even for first-use licenses, does not undermine my conclusion.

Declaration

I declare under penalty of perjury that the foregoing is true and correct.

Executed on: April 3, 2008

William M. Landes

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FIGURE 1

INTENTIONALLY OMITTED

2a

Figure 2a
Average Mechanical Royalty Income for Universal Songwriters, 2007 Dollars
Full Songwriter Sample

REDACTED

2b

Figure 2b
Median Mechanical Royalty Income for Universal Songwriters,
2007 Dollars
Full Songwriter Sample

REDACTED

Figure 3a
Average Mechanical Royalty Income for Universal Songwriters, 2007 Dollars
Songwriter Subgroup

REDACTED

Figure 3b
Median Mechanical Royalty Income for Universal Songwriters, 2007 Dollars
Songwriter Subgroup

REDACTED

Figure 4a
Average Total Royalty Income for Universal Songwriters,
2007 Dollars
Full Songwriter Sample

REDACTED

4b

Figure 4b
Median Total Royalty Income for Universal Songwriters, 2007
Dollars
Full Songwriter Sample

REDACTED

Figure 5a
Average Total Royalty Income for Universal Songwriters,
2007 Dollars
Songwriter Subgroup

REDACTED

5b

Figure 5b
Median Total Royalty Income for Universal Songwriters, 2007
Dollars
Songwriter Subgroup

REDACTED

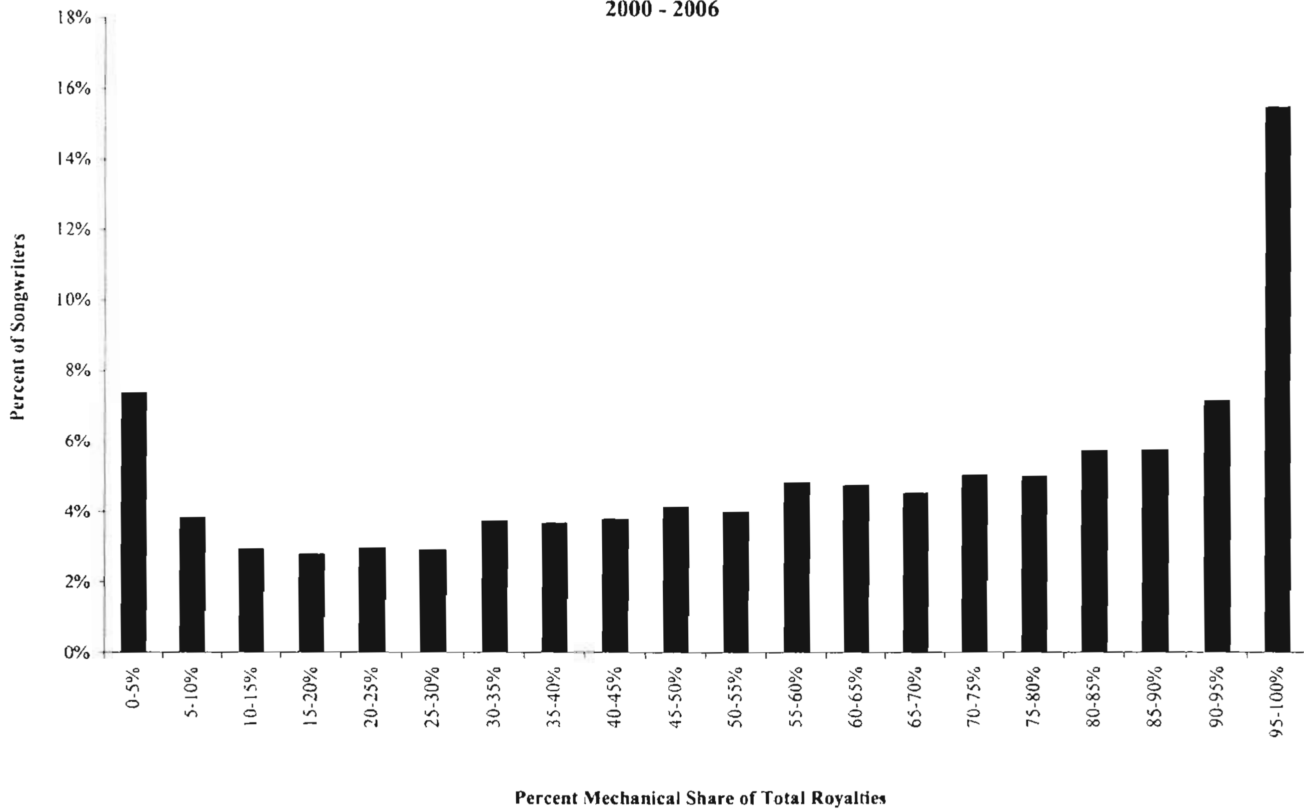
Figure 6
Distribution of Total Royalties
Universal Songwriters
2000 – 2006 Full Songwriter Sample

REDACTED

Figure 7
Distribution of Total Royalties
Universal Songwriters
2000 – 2006 Songwriter Subgroup

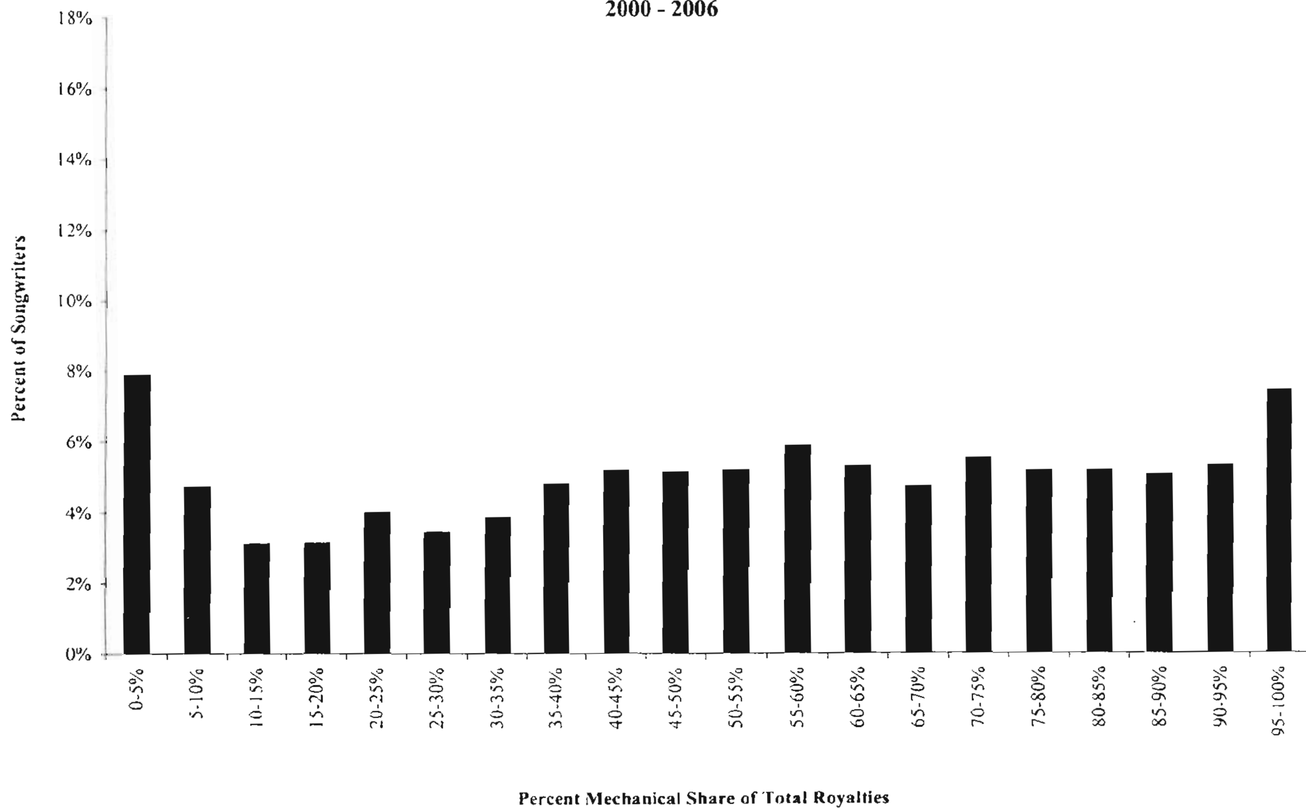
REDACTED

Figure 8
Distribution of Mechanical Royalties as a Share of Total Royalties
Universal Songwriters, Full Songwriter Sample
2000 - 2006



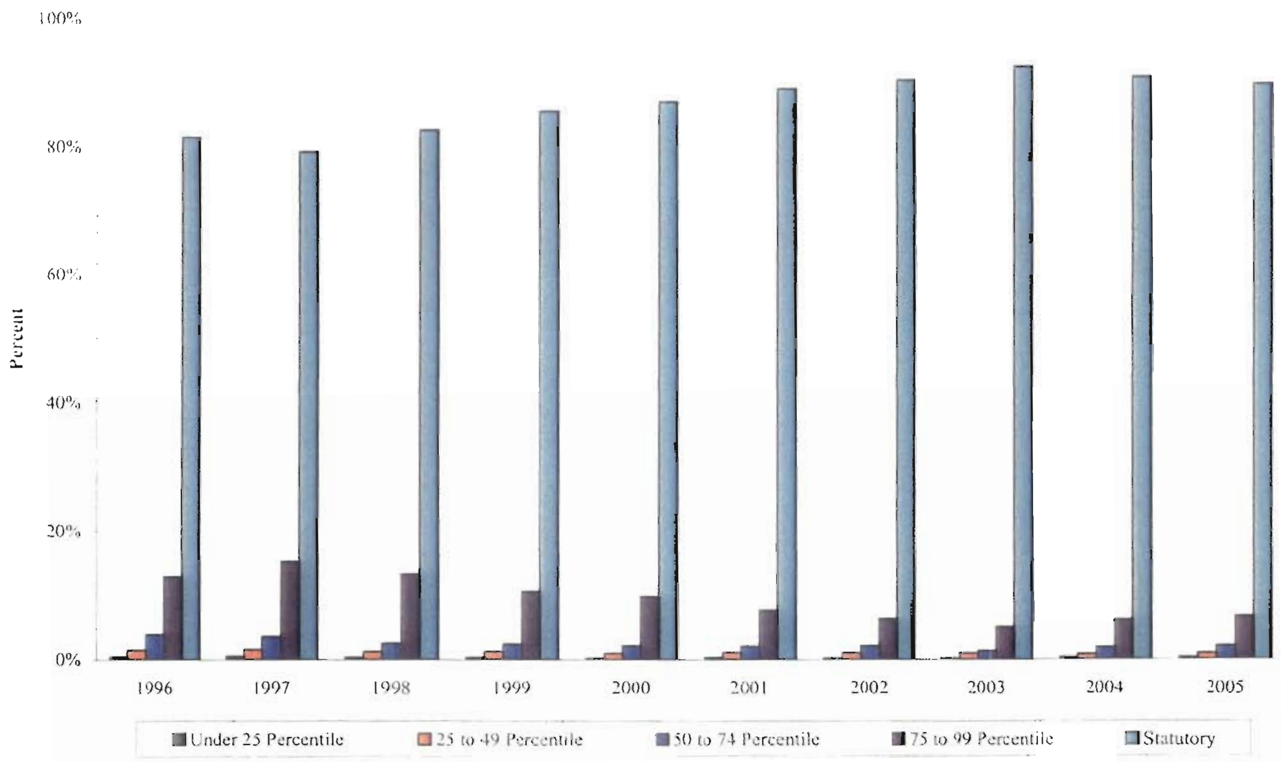
Source: Universal Music Publishing Royalty Database.
Full Songwriter sample includes songwriters earning Universal royalties in every year.

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

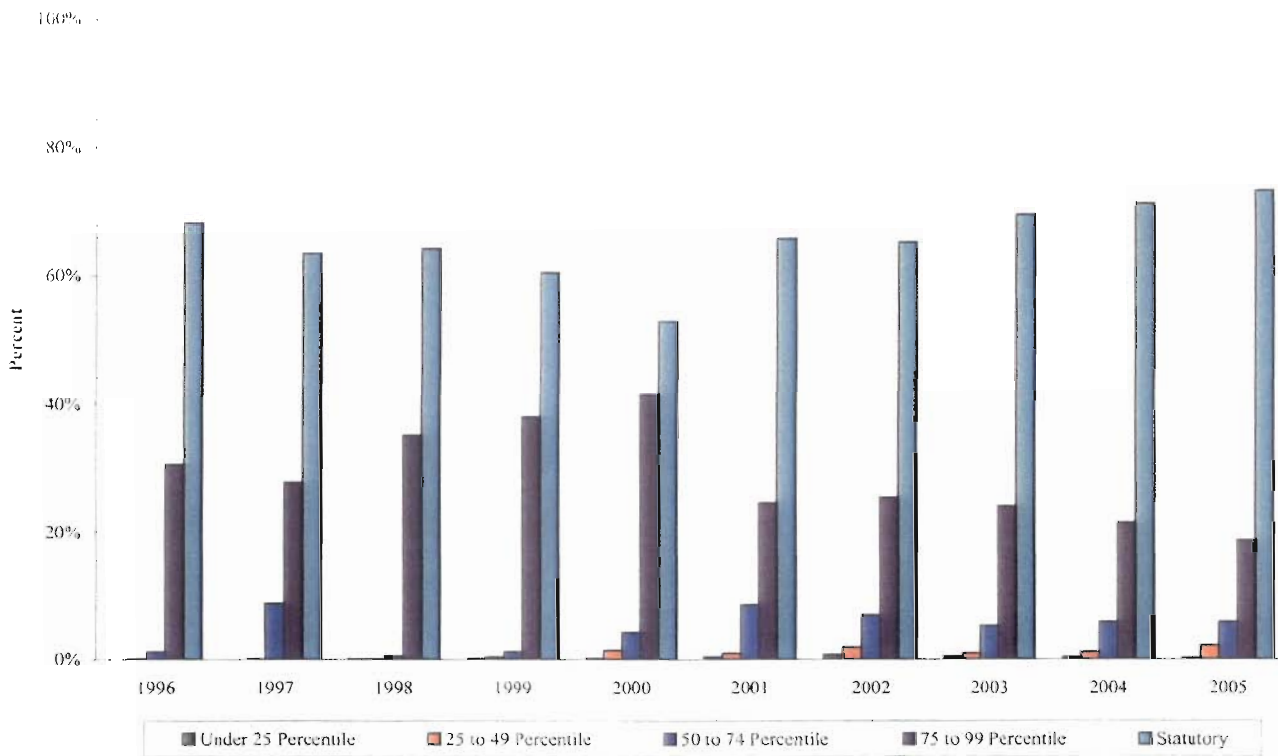


Source: Universal Music Publishing Royalty Database.
Songwriter Subgroup is a subset of the Full Songwriter sample.
It excludes songwriters earning less than $7,000 and the top 1% of earners over 2000 - 2006.

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



Source: HFA License Database.



Source: HFA License and Distribution Databases.

A

Documents Considered or Relied Upon in Connection with Rebuttal Report

I. Written Direct Testimony

A. David J. Teece
B. Margaret E. Guerin-Calvert
C. Linda McLaughlin
D. Eddy Cue
E. Ron Wilcox
F. Andrea Finkelstein

II. Trial Testimony

A. David J. Teece
B. Margaret E. Guerin-Calvert
C. Linda McLaughlin
D. Eddy Cue
E. Ralph Peer
F. Andrea Finkelstein

III. Deposition Testimony

A. David J. Teece
B. Margaret E. Guerin-Calvert
C. Linda McLaughlin

IV. Publisher Databases

A. HFA Licensing Database
B. HFA Distribution Database
C. HFA Royalty Compliance Database
D. Universal Music Publishing Group Royalty Database
E. EMI Music Publishing Royalty Database

V. Publisher Financial Information

A. Sony/ATV Music Publishing financial information (CO 7014022-7014023)
B. EMI Music Publishing financial data (CO 4024775-4024794)
C. EMI Music Publishing data on advances
D. BMG Music Publishing financial information (CO 5007221-5007240)
E. Universal Music Publishing financial reports (CO 9007805-9007936; CO 9007668-9007803; CO 9009185-9009335; CO 9008866-9009011; CO 9009013-9009183).
F. Universal Music Publishing royalty revenue data
G. Universal Music Publishing data on mastertone songs and income
H. Warner-Chappell Music Publishing royalty revenue data

I. Warner-Chappell Music Publishing data on advances

VI. Template Artist Contracts

A. Atlantic / Elektra / Warner (RIAA 45314-45348)
B. Atlantic / Warner (RIAA 45349-45401)
C. Atlantic / Warner / Rhino (RIAA 45261-45313)
D. Universal Records (RIAA 17488-17545)
E. Interscope / Geffen / A&M (RIAA 17380-17487)
F. Verve (RIAA 17543-17610)

VII. Academic Work

A. Augier and Teece, "Dynamic Capabilities and Multinational Enterprise," 47 *Management International Review* 2 (2007), 175-192
B. Teece, Pisano and Shuen, "Dynamic Capabilities and Strategic Management," 18 *Strategic Management Journal* 7 (1997), 509-533
C. Teece and Pisano, "The Dynamic Capabilities of Firms: An Introduction," 3 *Industrial and Corporate Change* 3 (1994), 537-556

VIII. News Articles

A. "The DAT Pact," Popular Electronics,
B. "Apple mulls unlimited music bundle," FT.com, March 18, 2008
C. "Fee for All," Portfolio.com, March 27, 2008

IX. Other Information

A. Final Determination of Rates and Terms, *In the Matter of Determination of Rates and Terms for Preexisting Subscription Services and Satellite Digital Audio Radio Services*, Docket No. 2006-1 CRB DSTRA
B. Adjustment of Royalty Payable Under Compulsory License for Making and Distributing Phonorecords (C.R.T. 1981), 46 Fed. Reg. 10466
C. Backup data to written direct testimony of Linda McLaughlin (RIAA 8423-8430 / Copyright Owners' Trial Exhibit 41
D. US Bureau of Labor Services, CPI for All Items, All Urban Wage Earners and Clerical Workers
E. European Central Bank US Dollar to Euro Exchange Rate.