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

REPLY CONCLUSIONS OF LAW OF THE DIGITAL MEDIA ASSOCIATION ("DiMA") AND ITS MEMBER COMPANIES AOL, LLC; APPLE INC.; MEDIANET DIGITAL, INC.; AND REALNETWORKS, INC.

Fernando R. Laguarda, DC Bar No. 449273
Thomas G. Connolly, DC Bar No. 420416
Charles D. Breckinridge, DC Bar No. 476924
Kelley A. Shields, DC Bar No. 978140
HARRIS, WILTSHIRE & GRANNIS LLP
1200 Eighteenth Street, NW
Washington, DC 20036
Telephone: (202) 730-1300
Facsimile: (202) 730-1301
laguarda@harriswiltshire.com
tconnolly@harriswiltshire.com
cbreckinridge@harriswiltshire.com
kshields@harriswiltshire.com

Counsel for The Digital Media Association

July 18, 2008

Table of Contents

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

REPLY CONCLUSIONS OF LAW OF THE DIGITAL MEDIA ASSOCIATION ("DiMA") AND ITS MEMBER COMPANIES AOL, LLC; APPLE INC.; MEDIANET DIGITAL, INC.; AND REALNETWORKS, INC.

The Digital Media Association ("DiMA"),[1] joined by AOL, LLC; Apple Inc. (f/k/a "Apple Computer, Inc."); MediaNet Digital, Inc. (f/k/a "MusicNet, Inc."); and RealNetworks, Inc., who have each filed individual notices of participation in this proceeding,[2] respectfully submit the following Reply Conclusions of Law in response to the conclusions of law filed by The National Music Publishers' Association, Inc., the Songwriters Guild of America and the Nashville Songwriters Association International (the "Copyright Owners") and in support of DiMA's requested rates and terms for the compulsory license pursuant to 15 U.S.C. § 115.

---

1 Established in 1998, DiMA is a national trade organization devoted primarily to the online audio and video industries, and more generally to commercially innovative digital media opportunities.

2 Napster, LLC and Yahoo!, Inc. each filed individual notices of participation and joined DiMA's Written Direct Testimony but have since withdrawn from the proceeding.

I. THE COPYRIGHT OWNERS IGNORE CONTROLLING PRECEDENT AND THE BEST POSSIBLE BENCHMARK

1. **CO PCL ¶¶ 1-6.**[3] In forty-five pages of proposed conclusions of law, the Copyright Owners fail to mention the principal controlling cases applicable to this proceeding. *See Recording Indus. Ass'n of America v. Copyright Royalty Tribunal*, 662 F.2d 1 (D.C. Cir. 1981) ("*RIAA*") (affirming in part the application of Section 801(b)(1) to determine rates under Section 115); *Recording Indus. Ass'n of Am. v. Librarian of Congress*, 176 F.3d 528, 532 (D.C. Cir. 1999) ("*RIAA II*") (affirming in part the application of Section 801(b)(1) to determine rates under pre-existing Section 114). Instead, they miniaturize the record evidence and string together a series of ratesetting citations applying inapposite legal standards to different parties and different licenses. The resulting conclusions of law provide no relevant guidance to the Court, which is strictly tasked with achieving the statutory objectives set forth in 17 U.S.C. § 801(b)(1).

2. **CO PCL ¶¶ 7-8.** For permanent downloads, a low percentage of revenue rate with minimum fees that provide downside protection without preventing price flexibility best achieves the statutory objectives in a manner consistent with applicable precedent. *See* DiMA PCL § III; DiMA PFF § X. Regardless of how the Court decides to approach its task of achieving the statutory objectives, the 2006 U.K. Settlement Agreement is the most comparable marketplace benchmark in the record, covering the same parties and basket of rights for roughly 8 percent of retail revenue. *See* DiMA PFF § IX(B); DiMA PCL ¶ 77. The last time rates were set for the mechanical license the

[3] For the convenience of the Court, DiMA's reply findings generally follow the structure of the Copyright Owners' proposed findings and indicate the paragraph numbers used by the Copyright Owners to which a reply is being made.

outcome was roughly 5 percent of retail revenues, which the parties twice ratified in subsequent negotiations intended to maintain parity with inflation. *See* DiMA PFF § IX(D); DiMA PCL ¶ 78. Adjusting the U.K. outcome down to 6 percent of retail revenues to recognize the different basket of rights, evidence of the undisputed evolution of the U.S. recorded music marketplace since 1981, and information about licensing in other foreign markets is consistent with prior application of the statutory objectives. *See* DiMA PCL § III(E). For remaining uses, the parties' partial settlement on limited downloads and interactive streaming, including all known incidental digital phonorecord deliveries, forms the basis for statutory rates and terms to be adopted by the Court. *See* 17 U.S.C. § 801(b)(7)(A).

II. THE FUNDAMENTAL PURPOSE OF THIS PROCEEDING IS TO FACILITATE THE REPRODUCTION AND DISTRIBUTION OF COPYRIGHTED MUSIC

3. **CO PCL ¶¶ 9-10.** The Copyright Owners agree (as they must) that the statutory license at issue in this proceeding "regulates the price of music" in order to "guarantee full access" by copyright users. *Adjustment of Royalty Payable Under Compulsory License for Making and Distributing Phonorecords*, 46 Fed. Reg. 10,466, 10,480, 10,483 (Feb. 3, 1981). As the Librarian of Congress has noted, the purpose of this regulation is "to lower the entry barriers for potential users of that music." *Determination of Reasonable Rates and Terms for the Digital Performance of Sound Recordings*, 63 Fed. Reg. 25394, 25409 (May 8, 1998) (emphasis supplied). The license thus ensures that copyright owners do not use the rights granted to them by Congress to raise the costs of, impede, prevent or seek to control the development of new technology

that delivers or plays music. *See* H.R. Rep. No. 60-222, at 7 (1909) (statutory license created to prevent monopolization of musical playback technology by copyright owners).

4. **CO PCL ¶¶ 11-22.** For this reason, the Copyright Owners' argument that the statutory license is to be "construed narrowly" is plainly incorrect. First, "the legislative history of the Copyright Act of 1909 states that from its inception, this compulsory license was intended to include all 'mechanical reproductions' and . . . [cover] 'all use' made of [a] composition." *Mechanical and Digital Phonorecord Delivery Rate Adjustment Proceeding*, Docket No. RF 2006-1, 71 Fed. Reg. 64,303, 64,307 (Nov. 1, 2006) (citing H. R. Rep. No. 60-2222, at 7 (1909)) (emphasis in original). Second, when Congress updated the license for digital uses, it confirmed that the license's purpose was to ensure that Copyright Owners would not use their exclusive reproduction and distribution rights to stifle new technology. *See* S. Rep. 104-128, at 37 (Aug. 4, 1995) (envisioning how the license will permit "new technologies [to deliver] phonorecords . . . by wire or over the airwaves"). Thus, Congress has repeatedly made clear its intention to lower entry barriers to the advancement and development of all forms of "new technologies" that can employ the statutory license to the benefit of consumers. The Copyright Owners' argument to the contrary is no more than wishful thinking.

5. **CO PCL ¶¶ 23-24.** To be sure, the Act allows parties to enter into voluntary license agreements that supersede the rates and terms to be set in this proceeding. *See* 17 U.S.C. § 115(c)(3)(E). There is no record evidence, however, that licensees other than record companies do so at less than the statutory rate. Moreover, the most widely used discounting tool the record companies rely upon is the so-called

"controlled composition clause," which Congress has forbidden record companies from using on digital deliveries such as permanent downloads for works from songwriter contracts since June 22, 1995. *See* 17 U.S.C. § 115(c)(3)(E). There is no record evidence that digital music distributors can or do rely on controlled composition clauses or any other practicable alternative to discount the statutory rate. Thus, consistent with the purpose of the compulsory license, the Court must ensure that rates are set at a level that facilitates marketplace entry – regardless of voluntary agreements.

III. RATES MUST BE CALCULATED TO ACHIEVE THE STATUTORY OBJECTIVES, NOT MIRROR MARKETPLACE OUTCOMES

6. **CO PCL ¶¶ 25-27.** The Copyright Owners proceed as if the words of the statute had no meaning and had never before been interpreted. The D.C. Circuit has made clear, however, that it is "simply wrong" to claim that Section 801(b)(1) "requires the use of 'market rates,'" or begins by "determin[ing] the range of market rates" against which the statutory objectives are applied. *Recording Indus. Ass'n of Am. v. Librarian of Congress*, 176 F.3d 528, 532-33 (D.C. Cir. 1999) ("*RIAA II*") (emphasis in original); *see also id.* at 533 ("The statute does not use the term 'market rates,' nor does it require that the term 'reasonable rates' be defined as market rates."). Without question, the standard for setting rates under Section 801(b) "is not fair market value." *Determination of Reasonable Rates and Terms for the Digital Performance of Sound Recordings,* 63 Fed. Reg. 25,394, 25,399 (May 8, 1998); *accord Determination of Rates and Terms for Preexisting Subscription Services and Satellite Digital Audio Radio Services*, 73 Fed. Reg. 4080, 4084 (Jan. 24, 2008) ("market rates" are not the starting point for application of the statutory objectives).

A. The Copyright Owners Identify the Wrong Criteria for Selecting Benchmarks

7. **CO PCL ¶ 28.** Proceeding from the incorrect premise that the task before the Court is to set "market rates" by identifying "marketplace benchmarks," the Copyright Owners fail to provide the Court with the guidance the statute requires. Clearly, benchmarks can be useful in determining rates. But the criteria proposed by the Copyright Owners are inapt. First, "the statutory objectives" – not marketplace benchmarks – determine the range of reasonable rates from which to determine the end result. *RIAA*, 662 F.2d at 9; *see also RIAA II*, 176 F.3d at 534 (affirming Librarian's express reliance on the statutory objectives throughout the ratesetting process); 63 Fed. Reg. at 25,406 (range of reasonable rates from which eventual rate selected itself must be "calculated to achieve the statutory objectives"). Therefore, while there is no formula for setting rates, each step of the process must be ordered to achieve the statutory objectives – including the selection of comparators if any are to be used. Merely choosing marketplace benchmarks for purposes of later adjustment in light of the statutory objectives is not sufficient. *See* DiMA PCL § II.

8. **CO PCL ¶¶ 29-32.** The Copyright Owners recognize correctly that benchmarks are less useful if they do not involve similar parties or similar rights, or if they reflect the use of market power. *See*, *e.g.*, 73 Fed. Reg. at 4088 (discussing "comparability"). But by indiscriminately string-citing an assortment of ratesetting decisions, they provide little guidance on this issue to the Court. Whether a benchmark is meaningful or not for purposes of Section 801(b)(1) depends principally on whether it helps to achieve the statutory objectives. For example, the Copyright Royalty Tribunal considered mechanical rates from other countries when it set the mechanical rate under

Section 801(b)(1) in 1981. *See* 46 Fed. Reg. at 10,484; *see also id.* at 10483 (foreign rates are relevant as "one measure of whether copyright owners in the United States are being afforded a fair return"). Likewise, the Librarian relied upon an agreement to pay royalties to sound recording copyright owners before they were entitled to them when later setting rates for digital performance rights under Section 801(b)(1). *See* 63 Fed. Reg. at 25,404. Without question, "market" agreements can be and have been very useful under Section 801(b)(1) – but they do not define the limit of potentially relevant comparators.

B. The Copyright Owners Fail to Show How Their Benchmarks Can Help Determine Rates for the Statutory License

9. **CO PCL ¶¶ 33-35.** In light of the foregoing, the benchmarks offered by the Copyright Owners are entirely inappropriate. First of all, to determine how to achieve the statutory objectives in setting a rate for permanent downloads, Dr. Landes does not even mention the statutory objectives or how they are relevant to selecting benchmarks. This alone casts substantial doubt on his proposal. Beyond that, he relies on benchmarks for rights that are not comparable. The rights at issue in this proceeding are for the reproduction and distribution of a musical work by means of a digital phonorecord delivery, specifically a permanent download. *See* 17 U.S.C. 115; DiMA PFF ¶ 36. None of the agreements Dr. Landes considered covered both of those rights and none pertains in any respect to permanent downloads. In fact, the most comparable benchmark in the record is the U.K. Settlement Agreement, which covers comparable rights, parties, and products. *See* DiMA PCL ¶¶ 77-79; DiMA PFF § IX(B).

10. **CO PCL ¶¶ 36-37.** Moreover, Dr. Landes chose his benchmarks because he claimed they provide information about the "relative value" of musical works and

sound recordings. By this bizarre logic, the greater the expenses incurred for sound recording rights in general, the higher the royalty for mechanical rights should be. Not only is there no precedent for such an outcome, it is completely inconsistent with the purpose of the compulsory license to lower entry barriers. *See supra* ¶¶ 3-4**.** Indeed, it is the opposite of what the statutory objectives require. *See* 17 U.S.C. § 801(b)(1)(C) (rate shall be calculated "[t]o 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"). Moreover, there is no support in the record for the implicit assumption Dr. Landes makes that the "relative value" reflected at the point in time the rights were negotiated in a package should always be the same if the rights are negotiated separately.

11. **CO PCL ¶¶ 38-42.** The Copyright Owners further confuse matters in two ways. First, they insist wrongly that the Court is charged with determining the closest approximation to "a market rate." Section 115 and Section 801(b)(1) plainly do not require such an outcome. *See supra* ¶ 6. Second, they construct a hopelessly broad "zone of reasonableness" based on their selected market benchmarks instead of beginning with the statutory objectives. *See* CO PCL ¶ 41. Applicable precedent makes clear that the reasonableness of any "zone" depends principally on adherence to the statutory objectives, not the use of "market" rates. *See, e.g.*, 662 F.2d at 9 (statutory objectives determine the range of reasonable rates); 63 Fed. Reg. at 25,406 (affording deference to choose rate so long as "zone" is calculated to achieve the objectives). Nor can the Copyright Owners salvage Dr. Landes's reliance on the Audio Home Recording Act by

referring to it now as mere "corroboration" because it "concerns" royalties earned by copyright owners of musical compositions and sound recordings. Even if it did reflect the "relative value" of these rights in the legislative process, such a benchmark is legally inapt. *See supra* ¶ 10.

12. **CO PCL ¶¶ 43-44.** Finally, the Copyright Owners argue that the statutory rate acts as a ceiling in an attempt to convince the Court to set a "market derived rate" as high as possible. Of course, the rates set here cannot be simply "market derived," as that would be inconsistent with both Section 115 and Section 801(b)(1). *See supra* ¶ 6. The argument to consider the rate a "ceiling" under which voluntary licenses can be negotiated is nothing more than an attempt to dress up the thoroughly discredited "bargaining room" theory and encourage the Court to set an unjustifiably high rate. *See* 46 Fed. Reg. at 10,478, *aff'd* 662 F.2d at 11-12 (Congress did not intend to encourage or facilitate bargaining). The purpose of the statutory license is to regulate the price of music so that any user can rely on it to enter the marketplace. *See supra* ¶¶ 3-4. Arguing that the rate is a "ceiling" under which bargaining can occur is plainly erroneous.

C. The Copyright Owners' Proposed Rates Are Completely Unreasonable

13. **CO PCL ¶¶ 45-53.** The Copyright Owners attempt to defend their proposed rates for permanent downloads with reference to the benchmarks Dr. Landes offers. As set forth above, however, those benchmarks are inapt since they deliberately ignore the statutory objectives and represent totally different products without any adjustment. *See supra* ¶¶ 7-12. The fact that Dr. Landes would agree that any rate (up to or perhaps even exceeding the entire 70 cents paid to record companies) would still be merely a ceiling and could be adopted without adjustments should cast substantial doubt

on his opinion. *See* DiMA PFF ¶ 278 n.15. The fact that his own benchmarks would support any rate up to 35 cents per song (based on the 70 cents currently paid to the labels, despite falling retail prices) is further reason to doubt his endorsement of the Copyright Owner proposal. *See id.* ¶ 284. And none of the benchmarks contain inflation adjustments as proposed by the Copyright Owners, *see* CO PFF ¶¶ 584-586, demonstrating how exorbitant that aspect of their proposal is.

14. To the contrary, the record clearly supports DiMA's proposed rates and terms. Given widespread access to free pirated music, the price of music offerings must be low enough for sellers to attract buyers. *See* DiMA PFF § III(A)(2). Potential buyers are attracted by innovative and ever-improving offerings, which require consistent investment and risk-taking. *See id.* §§ IV(A), V(C). This puts pressure on margins, which in turn requires digital music distributors to keep costs as low as possible. *See id.* § V(D). Imposing higher fixed penny rates in this industry would impede expansion and kill nascent entry. *See id.* ¶¶ 136-137; § VII(B). A percentage-of-revenue rate structure with a rate set at a lower, entry-enhancing level would best achieve all of the statutory objectives. *See id.* § VII(A). The U.K. Settlement Agreement provides a directly relevant benchmark in this regard, and this approach is broadly consistent with the prior proceeding to set rates for this license. *See id.* §§ IX(B), IX(D).

D. DiMA and the RIAA Provide Benchmarks that Achieve the Statutory Objectives

15. **CO PCL ¶¶ 54-60.** Unlike the Copyright Owners, DiMA and the RIAA have provided the Court with useful benchmarks for consideration in this proceeding. First, as set forth above, *see supra* ¶ 6, the purpose of this proceeding is not to mirror a marketplace outcome but to achieve the statutory objectives. Second, as also set forth

above, *see supra* ¶¶ 7-8, benchmarks can be helpful if they are selected with reference to the statutory objectives. They do not need to be thoroughly "free market" transactions, since that is not the principle behind the compulsory license or the statutory objectives. Rather, they must be comparable enough to provide meaningful guidance.

16. **CO PCL ¶¶ 61-67.** The Copyright Owners ignore the fact that rates for mechanical licenses in foreign markets were relied upon heavily in the 1981 proceeding affirmed on appeal, and they are clearly useful comparators for the Court. *See* DiMA PCL ¶ 73. While there are differences in the markets and scope of rights and payment terms, recognizing these differences does not reduce the utility of the comparisons. *See, e.g., id.* ¶¶ 73-81. The record evidence establishes that the United Kingdom is a comparable marketplace to the United States in terms of digital music. *See* DiMA PFF ¶¶ 316-318. The parties and rights involved are comparable as well. *See id.* ¶¶ 319-323. For this reason, the recent agreement covering mechanical rights in the United Kingdom is highly probative as to the value of this country's Section 115 license.

17. Finally, the Copyright Royalty Tribunal's 1981 determination has relevance for confirming the appropriate outcome in this proceeding. *See* DiMA PCL ¶ 78. First, the decision provides valuable context because it highlights the relevant marketplace considerations that were deemed important the last time the statutory objectives were determined in a contested proceeding and affirmed on appeal. It therefore serves as a valuable reference point for evaluating changes that have happened since then. *See* DiMA PFF ¶¶ 333-334. Second, the 1981 decision provides insight into an appropriate rate because the original relative allocation of revenues to copyright owners and users was affirmed on appeal and twice ratified by the industry through

voluntary agreements in 1987 and 1997. *See id.* The radical transformation of industry conditions since the late 1990s points decidedly towards a different rate structure and a different allocation of revenues (a lower rate) compared to 1981. *See id.*

E. Determining a Reasonable Rate Requires Close Adherence to the Statutory Objectives

18. **CO PCL ¶ 68.** The Copyright Owners treat the statutory objectives as mere "considerations" rather than legal commands in an attempt to minimize the significance of the plain language of the statute. To the contrary, nothing in the Act suggests that the four objectives are discretionary. *See* 17 U.S.C. § 801(b)(1) (rates "shall" be calculated to achieve the objectives). Accordingly, the Copyright Royalty Tribunal's 1981 decision was upheld "specifically because [it] followed the statutory objectives." *RIAA II*, 176 F.3d at 534. Indeed, "the term 'reasonable copyright royalty rates' . . . takes its meaning from" the objectives. *Id.* at 532 (emphasis supplied).

19. The use of the word "policy" in cases applying the objectives should not mistakenly be interpreted as relegating the statutory text to merely advisory status. The statute itself provides "a mechanism" for implementing policy. *See* 63 Fed. Reg. at 25,409. But 17 U.S.C. § 801(b)(1) is a statute. The D.C. Circuit has plainly indicated that failure to give thorough consideration to the statutory objectives in this type of proceeding would be "grounds for reversal." *RIAA II*, 176 F.3d at 534. Nonetheless, that is precisely what the Copyright Owners suggest the Court do.

20. **CO PCL ¶¶ 69-73.** For these reasons, rates can not be set merely to mirror a marketplace outcome. *See* 63 Fed. Reg. at 25,409 (statutory rate must achieve specific objectives set forth by Congress). Indeed, if Congress had intended the Court to replicate a market outcome or the result of marketplace benchmarks, it would have "used

the term 'market rate' or its equivalent." *RIAA II*, 176 F.3d at 533 (emphasis supplied). To the contrary, Section 801(b)(1) does not use the term "market rates" nor does it require that reasonable rates approximate market rates. *Id.*; *see also* DiMA PCL ¶¶ 21-25. Thus, the Copyright Owners are wrong to gloss over the text of the statute and urge the Court merely to "satis[y]" its obligation in a manner "consistent with reasonable market outcomes" where the objectives are "already factored into the negotiated price" with "no adjustment." CO PCL ¶¶ 69-72.

21. It is particularly misleading to assert, as the Copyright Owners do, that "marketplace evidence, standing alone" has ever been enough to satisfy the statutory objectives when no case stands for that proposition. CO PCL ¶ 73. In one particularly stunning example of misreading precedent, the Copyright Owners cavalierly cite *Amusement & Music Operators Association v. Copyright Royalty Tribunal*, 676 F.2d 1144 (7th Cir. 1982) – which affirmed the determination of a jukebox royalty in 1982 – for the proposition that the statutory factors can essentially be ignored. *See* CO PCL ¶ 71. In fact, the 7th Circuit was careful to point out that the Copyright Royalty Tribunal determined a rate "specifically in light of the four statutory criteria of Section 801(b)." *Amusement & Music Operators Ass'n*, 676 F.2d at 1157 (emphasis supplied). Moreover, the Copyright Owners tellingly omit the key fact that the rate affirmed by the 7th Circuit "could not be directly linked to marketplace parallels." *Id.* (emphasis supplied).

1. Maximizing the Availability of Creative Works to the Public Requires Making Those Works Accessible

22. **CO PCL ¶¶ 74-80.** Section 801(b)(1)(A) requires the Court to set a rate that "maximize[s] the availability of creative works to the public." 17 U.S.C. § 801(b)(1)(A). The Copyright Owners wrongly attempt to convert this into a

restatement of "American copyright law," which they blithely assert rewards rent-seeking under all circumstances. *See* CO PCL ¶ 74. To the contrary, in light of the specific entry-barrier-reducing purposes of the Section 115 license, a rate that achieves the objectives set forth in Section 801(b)(1)(A) requires careful attention to growing the marketplace for the consumption of music, including by digital distributions such as permanent downloads. *See* DiMA PCL ¶¶ 31-33. Whether or not this constitutes an "efficient use of resources" or an "effective market," Congress already made the determination as to what principles should apply.

23. Moreover, with respect to their primary argument, the Copyright Owners provide no empirical evidence that songwriting output is connected in any way to the level of the penny rate or the absence of a percentage-rate structure. Indeed, the overwhelming empirical evidence is that songwriting output is connected to neither. *See* DiMA PFF § VI. For many years as the penny rate stayed flat or declined in real terms, songwriting output soared as a result of technological developments and marketplace innovation on the part of music users. *See id*. Around the world, songwriters are compensated on a percentage of revenue basis. *See id.* §§ VII(A)(5); IX(C). The Copyright Owners can cover their eyes to this if they wish, but the Court cannot.

24. The record evidence clearly indicates that retaining the penny-rate structure for permanent downloads and increasing the rate itself will harm entry and innovation. *See id.* § VII(B). And there is no record evidence that a higher rate for permanent downloads compared to physical product would achieve any statutory objective. It is true that there is no guaranteed increased revenue for copyright owners under DiMA's proposal. And it is true that copyright owners are not promised immediate

gratification under a percentage-rate structure. But that is not what the statutory objectives require.

25. There is no dispute that DiMA's member companies are expanding the legitimate sale of music to grow the overall music marketplace and the digital music industry in particular. *See id.* §§ III(B), IV(B). There is no dispute that these efforts expand revenues for songwriters. *See id.* § IV(B). And there is no serious dispute that growth is still fragile for the overwhelming majority of digital music distributors. *See id.* § V; *see also* CO PFF ¶ 831 (admitting that permanent download business model continues to evolve). As the Copyright Owners point to Apple's iTunes Store again and again, they merely showcase how difficult it is to succeed in the marketplace. *See* DiMA PFF § VIII(A)(4); ¶ 225. The Copyright Owners' proposal would make it harder yet to succeed. *See id.* § VIII(B).

26. A percentage-rate structure is ideally suited to maximize the availability of creative works to the public. *See id.* §§ VII, VIII(A), X. Lower rates (not higher rates) and true minima (not confiscatory minima that set unreasonable pricing floors) are the most sensible approach to growing the music marketplace and ensuring maximum compensation to copyright owners. *See id.*

2. Fairness Is Dictated by Existing Economic Conditions

27. **CO PCL ¶¶ 81-90.** Section 801(b)(1)(B) requires the Court to set a rate that provides fair compensation to copyright owners and copyright users "under existing economic conditions." 17 U.S.C. § 801(b)(1)(B). Justifying their exorbitant rate request, the Copyright Owners claim that the digital marketplace is "flourishing" and "projected to continue to grow" entirely on the basis of the success of Apple's iTunes Store. *See* CO

PCL ¶ 88. This makes about as much sense as pointing to the most successful songwriter and claiming that all songwriters are "flourishing." *See* DiMA RFF ¶ 74; s*ee also* DiMA PFF ¶ 248. In fact, the overwhelming weight of the evidence shows that the marketplace is undergoing a technological sea change while suffering the effects of rampant piracy. *See* DiMA PFF §§ III, V. DiMA's proposal recognizes the importance of growing the revenue pie for all industry participants through rates and a rate structure that recognize existing economic conditions.

28. With respect to considering how best to achieve the objectives of Section 801(b)(1)(B), it is particularly important not to hamper growth of digital music distributors. *See* 63 Fed. Reg. at 25,409 (rate should promote new entry). To this end, the Copyright Royalty Tribunal emphasized that Section 801(b)(1)(B) "regulates the price of music" specifically with the objective of "permit[ting] any [licensee] to enter the market at will." 46 Fed. Reg. 10,466, 10,480; *see also id*. (rates must "permit entry"); 63 Fed. Reg. at 25,409 (regulated rates under Section 801(b)(1)(B) should lower entry barriers for music licensees). As the Copyright Owners point out, the Copyright Royalty Tribunal rejected claims that the market conditions were softening in 1981, and it raised rates as a result. The situation is the reverse today. No one can dispute the changes that have occurred since then, nor the fragile state of the marketplace. Lower rates and a percentage-rate structure are required to achieve the objectives of Section 801(b)(1)(B) under existing economic conditions.

29. The Copyright Owners' argument to the contrary and their obsessive focus on Apple's iTunes Store are particularly inapt. First, this is an industry-wide proceeding affecting potential entrants as well as all existing marketplace players. *See* DiMA PFF

§ VIII(A)(4). Rates must expressly allow new entrants "the opportunity to earn a fair income." 46 Fed. Reg. 10,466, 10,480. The Copyright Owners fail completely to analyze new entrants or incipient business models in their proposal. Moreover, for existing distributors like RealNetworks, their proposal would cut gross margins on permanent downloads by 40 percent assuming stable prices. *See* DiMA PFF § VIII(B)(1). At lower prices, the impact would be even more severe. *See id.* Second, iTunes should be recognized for its contributions to the success of digital music and others should be encouraged to emulate it and grow the marketplace. iTunes represents an incredible (though unfortunately unique) success story that has produced substantial benefits for the entire industry. *See id.* § VIII(A)(4). Finally, the Copyright Owners' analysis of iTunes is flawed and misleading, as it makes a series of unjustified assumptions about the financial implications of a drastically reduced contribution margin after a nearly 65-percent rate hike. *See id.* ¶ 247. Thus, it cannot be relied upon as the Copyright Owners propose to justify a massive rate hike.

3. Digital Distributors Are Making the Most Substantial Relative Contributions to the Public Availability of Musical Works Via Permanent Downloads

30. **CO PCL ¶¶ 91-96.** Section 801(b)(1)(C) requires the Court to set a rate that reflects the relative roles of the copyright owner and copyright user over a range of considerations involved in making digital music products available to the public. *See* 17 U.S.C. § 801(b)(1)(C). Again, the Copyright Owners seek to trivialize this objective by referring to it as merely a "marketplace inquiry." CO PCL ¶ 91. Nothing could be more wrong. *See supra* ¶ 6. Of course the songwriter provides the song. That was true when Congress created the statutory license nearly 100 years ago and while it kept the rate at 2

cents per song for seventy years. But that does not change the record evidence demonstrating that in today's marketplace, digital music distributors make the overwhelming contributions in making permanent downloads available to the public. *See* DiMA PCL ¶¶ 50-60.

31. Digital distributors offer comprehensive catalogs and powerful Internet tools to entice consumers to buy music. *See* DiMA PFF § IV(A). They contribute the technology used with no assistance from the Copyright Owners. *See id*. §§ IV(A), V(B). They undertake massive capital investment while the Copyright Owners do not. *See id*. §§ V(B), VIII(B). They have large fixed and variable costs related to their digital businesses, while the Copyright Owners have none. *See id*. §§ V(B), V(C), VIII(B). They incur substantial risks to enter and remain in the marketplace. *See id*. § V(B). They open "new markets" for creative expression and media for their communication. *See id*. §§ III(B), IV, V. The Copyright Owners do none of this. *See id*. § VIII(B). For all of these reasons, this statutory objective weighs decisively and incontrovertibly in favor of adopting the low percentage rate DiMA has proposed for permanent downloads.

4. The Copyright Owners Fail to Explain How Their Massive Rate Hike and Inflexible Rate Structure Would Minimize Disruption

32. **CO PCL ¶¶ 97-100.** Section 801(b)(1)(D) requires the Court to set a rate that minimizes the disruptive impact on industry structure and prevailing practices. *See* 17 U.S.C. § 801(b)(1)(D). With this objective, the Copyright Owners seek again to limit the scope and meaning of the statutory text. To be sure, certain direct impacts that are irreversible in the short run are undoubtedly disruptive. The Copyright Owners – again – suggest no such drastic consequences for Apple's iTunes Store as a result of their proposed rate hike, so they conclude that all is well. But this is not the inquiry required

by the statutory objectives. Even if it were, the Copyright Owners (1) perform a flawed analysis of iTunes while (2) ignoring the impact on potential entrants as well as on other existing players like Napster, RealNetworks, and MediaNet, who sell a significant number of permanent downloads and whose product margins would be drastically cut under the proposed massive rate hike. *See* DiMA PFF ¶ 247. Finally, the Copyright Owners misleadingly suggest that anything less than threatening the "viability" of an industry cannot be disruptive. This is plainly wrong.

33. The Copyright Owners' suggestions are directly contrary to controlling precedent. In 1981, the Copyright Royalty Tribunal raised rates after it concluded that record labels had experienced significant growth as an industry. *See* 46 Fed. Reg. at 10,476. It found that record labels had been profitable as an industry. *See id.* at 10,483. It found that record labels could absorb cost increases profitably as an industry. *See id.* It found that even after higher royalty rates were imposed the record labels would have higher profit margins as an industry. *See id.* at 10,484. It found there was no probative evidence of any potential disruption – whether "substantial" or "immediate" or "irreversible" – as a result of increased rates. *See id.* at 10,481. The Copyright Owners' feeble efforts to use iTunes as a shield in defense of a massive and unprecedented rate hike affecting an entire industry is therefore hardly convincing.

34. **CO PCL ¶¶ 101-102.** Finally, the Copyright Owners argue that a reduction in rates will be unduly disruptive to them, but this is premised on their unsupported assumption that current sales would otherwise grow even after the massive rate hike they propose. The record evidence shows this assumption is flawed. *See* DiMA PFF ¶¶ 12, 73-74, 136-137, 185-188, 258. Indeed, the Copyright Owners concede the

existing pot of mechanical royalties is shrinking due to declining sales. *See* CO PFF ¶¶ 236-237. Their response is that lower demand for their product should result in a higher statutory rate or even higher prices. *See* DiMA PFF ¶ 258. Such a standard for avoiding disruption has no legal basis and is contrary to the record evidence.

IV. A PENNY-RATE STRUCTURE FAILS TO ACHIEVE THE STATUTORY OBJECTIVES

35. **CO PCL ¶¶ 103-105.** The Copyright Owners' arguments for maintaining the penny-rate structure are without support in the record and fail to acknowledge the statutory objectives. First, the Copyright Owners completely sidestep the controlling legal standard in supporting their desire to maintain the penny rate. Rather than explaining how a penny-rate structure achieves the statutory objectives, the Copyright Owners discuss a smattering of cases unrelated to Section 801(b)(1). Under the controlling statute, there is no requirement to "value usage," achieve a "per performance" metric, or to set a percentage rate only if a unit value is not "readily calculable." CO PFF ¶¶ 104-105.

36. Nor should DiMA's minimum-fee proposal be interpreted as a concession that a penny rate would not be disruptive. To be clear, the proposed minimum fee is intended to provide downside protection for songwriters, not an alternative rate calculation. *See* DiMA PFF §§ VII(A)(5), VIII(A). A percentage-rate structure with minima as DiMA proposes is consistent with the overwhelming majority of mechanical licenses from around the world. *See id.* § VIII(A)(5). Indeed, the Copyright Owners themselves admit there would be no disruptive impact from such a structure. *See id.* § VII(A).

37. **CO PCL ¶ 106.** The Copyright Owners argue wrongly that payments under the statutory license must increase on a unit basis in correlation with consumption of their works, as opposed to the value placed on the consumption of the works. The existence of percentage rates for mechanical licenses around the world belies this argument. *See id.* §§ VII(A)(5), IX(C). Moreover, the Copyright Owners argue that their incentives and those of digital music distributors may not be "perfectly aligned." But this is a red herring. There is no evidence that digital music distributors are not seeking to maximize revenues given that the fixed costs of digital music distribution are so high relative to the marginal cost of delivering each additional unit. *See id.* ¶¶ 147-170, 176-177, 182. And there is no evidence that a penny rate aligns incentives better than a percentage rate in this marketplace and under existing economic conditions. *See id.* § VII.

38. **CO PCL ¶¶ 107-112.** Finally, the argument that the penny rate has been in place since 1909 is irrelevant, since permanent downloads have barely been in the marketplace for five years. *See* CO PFF § VII(D)(1). Indeed, by the Copyright Owners' logic, adoption of a percentage rate for permanent downloads would be minimally disruptive because the product is so very new and it continues to evolve so rapidly. *See id.* ¶¶ 644, 831. Perhaps that is why no witness for the Copyright Owners provided any credible testimony as to the disruptive impact of adopting a percentage rate. *See* DiMA RFF § XIV(H).

39. As amply demonstrated in the record, attributable revenue should be defined so as to capture use of the musical works but nothing more. *See* DiMA PFF §§ VII(A)(2), VII(A)(7). DiMA's proposed definition is consistent with market

agreements and achieves the statutory objectives because it is not overly broad. *See id.*; *see also* 73 Fed. Reg. 4080 (adopting comparable definition of attributable revenue).

V. THE COURT SHOULD PROCEED WITH CAUTION IN ADOPTING TERMS CONTRARY TO THE MARKET-OPENING PURPOSES OF THE STATUTORY LICENSE

40. **CO PCL ¶¶ 113-116.** The Copyright Owners and the RIAA have proposed a number of "terms" related to the statutory license. As an initial matter, DiMA does not dispute the authority of the Court to adopt terms consistent with Section 115. *See* S. Rep. No. 104-128, at 40 (1995) (contemplating such regulations as are required for "the new digital transmission environment."); *see also* DiMA PCL § IV. But that authority must be exercised consistent with the undisputed purpose of Section 115, which is to lower entry barriers and permit new technologies to make and distribute phonorecords. *See generally* DiMA PCL § I.

41. **CO PCL ¶¶ 117-118.** First, the Copyright Owners propose a late fee of 1.5 percent per month, or 18 percent annually. There is no record support for such a fee. *See* DiMA PFF § VIII(B)(4). And as the RIAA correctly points out, the fact that Section 115 contains termination provisions for late payment already provides the Copyright Owners with the protections they seek. *See* RIAA PCL ¶ 242. Moreover, the fact that late fees exist in record company agreements with digital music services – over whom they have undisputed bargaining leverage to extract excessive fees, *see* DiMA PFF ¶ 152 – actually makes it less likely that these provisions "lower the entry barriers for potential users of . . . music." 63 Fed. Reg. at 25,409. Claiming (with no record support) that licensees "will not . . . accept" late fees in voluntary agreements essentially proves the point that they are unreasonable. CO PCL ¶ 117 n.4.

42. **CO PCL ¶ 119.** Next, the Copyright Owners propose a mandatory surcharge of 3 percent on all pass-through licenses. Again, there is no record support for this term. *See* DiMA PFF § VIII(B)(5). Moreover, it is inconsistent with the market-opening intent of the statutory license. *See* S. Rep. No. 104-128, at 37 (pass-through arrangements contemplated without "multiple payments"); s*ee also* RIAA PCL ¶¶ 244-249.

43. **CO PCL ¶¶ 120-121.** The Copyright Owners also propose the recovery of attorneys' fees expended to collect past due royalties. For the reasons set forth by the RIAA, the request far exceeds the limited scope of attorneys-fees recovery set forth in the Copyright Act, could potentially disrupt the operation of those provisions, and might be inconsistent with them as well. *See* RIAA PCL ¶¶ 250-257. The Copyright Owners failed in their opportunity to justify narrower provisions consistent with the purpose of the statutory license. *See* CO PFF ¶ 866. Thus, adoption of the attorneys-fees recovery term as proposed by the Copyright Owners would be arbitrary. *Cf. RIAA II*, 176 F.3d at 535-36 (vacating terms adopted without supporting evidence).

44. **CO PCL ¶¶ 122-124.** DiMA has no position with respect to the Copyright Owners' proposal to be paid on physical product ultimately returned to record companies. With respect to the Copyright Owners' proposal that licenses specify the configuration for which the license is sought, there is no need for this term, no record support for it, and no statutory basis to adopt it. *See* RIAA PFF ¶¶ 1833-1838; RIAA PCL ¶¶ 261-264.

45. **CO PCL ¶¶ 125-134.** Finally, on rebuttal, the Copyright Owners proposed an extraordinarily broad, nine-part, multi-faceted definition of revenue,

ostensibly in connection with their proposal for ringtone rates, which are the only rates they propose that rely upon a percentage of revenue. *See* CO PFF § III(B). The proposed definition makes no effort to apply a mechanical rate only to revenues attributable to the sale of music, but instead seeks to expand the revenue pool to anything remotely associated with music. *See id*.; DiMA RFF §§ III(B), XVII(D). As such, it lacks evidentiary support and would be massively disruptive to implement and administer. *See* DiMA RFF § III(B); *see also* 73 Fed. Reg. 4080, 4087 (Jan. 24, 2008) (criticizing SoundExchange proposal on same grounds and adopting proposal that "more unambiguously relates the fee to the value of the [rights] at issue").

46. Moreover, the Copyright Owners failed to offer a single witness who could explain the reasonableness of their proposal or its practicality from a business perspective. *See* DiMA RFF § III(B). Instead, the Copyright Owners offered Dr. Landes, who was incapable of explaining (1) how the definition would work in practice or (2) what would constitute attributable revenue under the definition. Instead, he proposed that "high-powered" attorneys "sit down and spend a good deal of time and effort" to work all of that out later. 5/20/08 Tr. 7456:4-10 (Landes). Clearly, the proposal lacks support in the record evidence and it would be arbitrary to adopt it. *Cf. RIAA II*, 176 F.3d at 535.

VI. REPLY TO THE RIAA'S PROPOSED CONCLUSIONS OF LAW

47. DiMA and the RIAA essentially agree that achieving the objectives set forth in Section 801(b)(1) requires the adoption of a percentage rate at a reasonable level. DiMA believes that a percentage of retail revenue is appropriate and achieves the statutory objectives, but that a percentage of wholesale is preferable to a penny rate. In

this regard, the RIAA's recommendation is not inconsistent with the statutory objectives or the goals of the compulsory license. Two issues raised by the RIAA merit a brief response.

48. First, the RIAA employs the statutory objectives primarily as a method to make adjustments to marketplace benchmarks. *See* RIAA PCL ¶¶ 33 (first step is to identify benchmarks), 62 (second step is to make adjustments to the benchmarks based on the statutory objectives). As DiMA points out above, this is not consistent with the plain language of the statute or applicable precedent. *Cf.* 73 Fed. Reg. at 4088 (parties unanimously agreed to begin with marketplace benchmarks). Instead, the appropriate first step is to determine how to achieve the objectives in light of the record evidence. *See supra* §§ I, III; *see also* DiMA PCL §§ II, V(E). Nevertheless, the RIAA does appropriately evaluate the record evidence in light of the statutory objectives and achieves an outcome that is consistent with those objectives in the end.

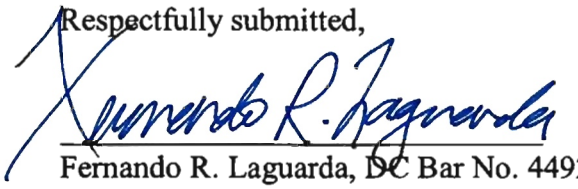
49. Second, whatever relevance the Copyright Owners' non-mechanical income has to determining the relative positions of the recording industry and the publishing industry, *see* RIAA PCL § II(D), there is no legal basis to consider the income of copyright users from sources other than the sale of musical works nor sufficient record evidence upon which to reach any determination on that basis even if it were permissible. *See* DiMA PCL ¶¶ 44-48. Section 801(b)(1) does not refer to the ancillary income of copyright users, directly or indirectly, and the RIAA cites no precedent relying specifically on copyright user non-mechanical income. Even if copyright users' ancillary income were relevant, the record evidence – particularly the undisputed economic conditions of rampant piracy and nascent and dynamic business models, *see* DiMA PFF

§§ III, V(A) – indicates that the statutory objectives are best achieved by a percentage of revenue rate structure at rate levels recommended by both DiMA and the RIAA.

CONCLUSION

50. For the reasons set forth herein and in the accompanying Reply Findings of Fact, the Court should adopt DiMA's Second Amended Proposed Rates and Terms.

Respectfully submitted,



Fernando R. Laguarda, DC Bar No. 449273
Thomas G. Connolly, DC Bar No. 420416
Charles D. Breckinridge, DC Bar No. 476924
Kelley A. Shields, DC Bar No. 978140
HARRIS, WILTSHIRE & GRANNIS LLP
1200 Eighteenth Street, NW
Washington, DC 20036
Telephone: (202) 730-1300
Facsimile: (202) 730-1301
laguarda@harriswiltshire.com
tconnolly@harriswiltshire.com
cbreckinridge@harriswiltshire.com
kshields@harriswiltshire.com

Counsel for The Digital Media Association

July 18, 2008

CERTIFICATE OF SERVICE

I hereby certify that on this 18th day of July 2008, I caused a true and correct copy of the foregoing "Reply Conclusions of Law of the Digital Media Association; AOL, LLC; Apple, Inc.; MediaNet Digital, Inc.; and RealNetworks, Inc." to be served by email and overnight mail on the following:

Robert E. Bloch
Mayer Brown Rowe & Maw LLP
1909 K Street, NW
Washington, DC 20006
rbloch@mayerbrown.com
Counsel for EMI Music Publishing

Jay Cohen
Aiden Synott
Lynn Bayard
Paul, Weiss, Rifkind,
Wharton & Garrison LLP
1285 Avenue of the Americas
New York, NY 10019
jaycohen@paulweiss.com
asynnott@paulweiss.com
lbayard@paulweiss.com
Counsel for NMPA, SGA, and NSAI

Paul M. Smith
Thomas J. Perrelli
Steven R. Englund
David A. Handzo
Molly J. Moran
Jared O. Freedman
JENNER & BLOCK LLP
1099 New York Avenue, N.W.
Suite 900
Washington, D.C. 20001
psmith@jenner.com
tperrelli@jenner.com
senglund@jenner.com
dhandzo@jenner.com
mmoran@jenner.com
jfreedman@jenner.com
Counsel for RIAA

I further certify that on this 18th day of July 2008, I caused a true and correct copy of the foregoing "Reply Conclusions of Law of the Digital Media Association; AOL, LLC; Apple, Inc.; MediaNet Digital, Inc.; and RealNetworks, Inc." to be served by email and first class mail on the following:

James D. Villa
American Online, Inc.
22000 AOL Way
Dulles, VA 20166
James.Villa@corp.aol.com

Bob Kimball, General Counsel
RealNetworks, Inc.
2601 Elliott Avenue
Seattle, WA 98121
bkimball@real.com

Kevin Saul
Matt Railo
Apple Computer, Inc.
1 Infinite Loop, MS 3-ITMS
Cupertino, CA 95014
ksaul@apple.com
mrailo@apple.com

David M. Israelite
National Music Publishers' Association Inc.
101 Constitution Avenue, N.W.
Washington, D.C. 20001
disraelite@nmpa.org

Steven M. Marks
Recording Industry Association of America, Inc.
1025 F. Street, N.W.
10th Floor
Washington, D.C. 20036
smarks@riaa.com

Rick Carnes
The Songwriters Guild of America
209 10th Avenue South, Suite 321
Nashville, TN 37203
rickcarnes@songwritersguild.com

George Cheeks, General Counsel
MTV Networks,
a division of Viacom, Inc.
1515 Broadway
New York, NY 10019
George.Cheeks@mtvn.com

Kathryn E. Wagner
Vice President & Counsel
National Music Publishers' Association
601 W. 26th Street, Fifth Floor
New York, NY 10001
kwagner@nmpa.org

Cindy Charles
Tom Rowland
MusicNet, Inc.
220 W. 42d Street
16th Floor
New York, NY 10036
trowland@musicnet.com
ccharles@musicnet.com

James Pickell
Ajay A. Patel
Sony Connect, Inc.
1080 Center Drive
Los Angeles, CA 90045
Jim.Pickell@sonyconnect.com
Ajay.Patel@sonyconnect.com

Aileen Atkins
Napster LLC
317 Madison Avenue
11th Floor, Suite 1104
New York, NY 10017
aileen.atkins@napster.com

Charles J. Sanders
Attorney at Law PC
29 Kings Grant Way
Briarcliff Manor, NY 10510
csanderslaw@aol.com

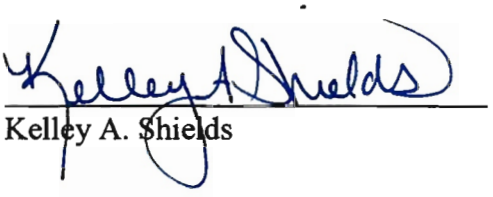
Carl W. Hampe
Baker & McKenzie LLP
815 Connecticut Avenue, N.W.
Washington, D.C. 20006
carl.hampe@bakernet.com

Barton Herbison
Nashville Songwriters Association Int'l
1710 Roy Acuff Place
Nashville, TN 37203
barton@nashvillesongwriters.com
Jennifer@nashvillesongwriters.com

James E. Hough
John F. Delaney
Morrison & Foerster LLP
1290 Avenue of the Americas
New York, NY 10104
jhough@mofo.com
jdelaney@mofo.com

William B. Colitre
Royalty Logic, Inc.
21122 Erwin Street
Woodland Hills, CA 91367
bcolitre@MusicReports.com

Wendy Halley
Yahoo!, Inc.
45 W. 18th Street, 6th Floor
New York, NY 10011
whalley@yahoo-inc.com



Kelley A. Shields